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Dear Mark

Initial Proposals on Transitional Incentive Schemes Supporting the Offtake Arrangements

Thank you for the opportunity to comment on the above initial proposals. In responding to Ofgem's document, we have set out our views on the high level issues that are associated with the proposed scheme. Thereafter, in a confidential Annex to this letter, we have provided more detailed comments on the proposed offtake quantities for both flat and flexibility capacity presented in Appendix 1 of Ofgem's document.

1. <u>High level issues with Ofgem's proposals</u>

(i) Exposure to demand growth.

In our previous correspondence and discussions with Ofgem on interim, transition and enduring offtake incentive arrangements, we have stated that it is vital that any future incentive regime includes a mechanism for adjusting the target offtake parameters in response to genuine changes in demand. As we described in our letter to you dated 25 August 2005, such changes may be caused by a variety of factors including:

a) **Genuine demand growth**. As you will appreciate, demand forecasting is not an exact science. Therefore, despite a network's best intention to be as accurate as possible in its demand forecasts, there is every likelihood that actual demand will vary when compared to forecast volumes. For example, the volatility of the non-domestic sector where large loads and interruptible loads switching to become firm loads for transportation purposes could have a material affect on offtake capacity requirements. In other words, it is apparent that there is considerable uncertainty about demand growth four and five years out. In addition, small deviations from the underlying demand forecasts could have significant (and disproportionate) implications for capacity requirements.

b) **Regulatory reform.** Regulatory reform of the DN exit and interruption regime is expected to take place from April 2007. Although the detail has yet to be determined, we believe that it is likely to result in a change to the volume of interruptible capacity connected to the DNs. For example, in the event that a charge is applied to interruptible sites there is a likelihood that some sites will opt to become firm and therefore, a DN's demand forecast will change accordingly. Clearly, therefore, an incentive target that is set ahead of that regime could unjustly penalise a DN unless an adjustment mechanism of some form is included within the scheme.

c) **Variation in Calorific Value (CV).** Although the offtake capacities (both flat and flex) are set in terms of energy, a variation in CV could impact a DN's capacity requirements. For example, a lowering of the CV could mean that any diurnal storage capacity within the network itself would no longer be sufficient to meet the requirements expected of it prior to change in CV. We have already experienced a decrease in CV this summer. There is also an expectation that gas quality (including CV) entering the NTS is likely to change further in coming years as Great Britain becomes increasingly dependent upon imported gas. The DN has no control over CV variation and, therefore, it would be inappropriate for the incentive scheme to penalise a DN for changes in offtake capacity requirements where actual CVs varied from those used when setting the target parameters.

Based on the above, and our previous discussions with Ofgem, we are extremely disappointed that these initial proposals for the transition incentive regime do not include a mechanism to adjust the *ex ante* targets where variation is at least attributable to one or more of the above factors. Indeed, without such a mechanism, as proposed Ofgem's incentive scheme would appear to be based upon a DN's demand forecasting capability/accuracy, rather than offtake capacity booking behaviour and associated network management.

We have given some consideration to how it would be possible to introduce such an adjustment mechanism. In our view, it would be possible to include a term in the incentive formula that would "automatically" adjust the target offtake capacities. For example, to derive the targets Ofgem has proposed that specific growth rates would be applied to the 07/08 "baseline" quantities. Therefore, rather than setting prescribed offtake capacity target quantities that have been calculated using these pre-defined parameters, the calculation itself could be inserted into the licence which would allow an adjustment term to be included where actual demand growth rates differ from Ofgem's pre-determined rates. Since growth rates could be influenced by at least each of the factors a) to c) above, we believe that a mechanism such as this should go some way to addressing our concerns.

Another possibility would be an amendment could be made to the existing income adjusting event provision set out in paragraph 8(6)(a) of Special Licence condition E2B (Restriction of revenue in respect of the Distribution Network transportation activity).

Such an amendment could mitigate a DN's exposure under the incentive mechanism if the exposure was as a result of a change in demand growth rate outwith its direct control. In our view, this would require an amendment to the £2m threshold that is currently within the licence as well as amendments to the paragraphs within the licence that define an income adjusting event. Clearly, this mechanism would need to capture changes that might arise from genuine unforeseen demand growth, reform to the regulatory regime and changes to CV over which the DN has no control. However, the income adjusting event mechanism only obliges Ofgem to *consider* changing targets in relation to such uncontrolled events. We would therefore also require comfort from Ofgem from the outset that the incentive scheme is not intended to expose DNs to unanticipated demand growth, changes to the regulatory regime or CV changes and, therefore, that a claim for such items under the income adjusting event provision would in principle be acceptable.

In the case of flex capacity, even these mechanisms could provide limited protection (for example, there is not a linear relationship between demand growth and flexibility requirements). We therefore believe that flexibility should be removed from the incentive scheme and reviewed as part of the main price control.

(ii) Value of the incentive.

When considering the potential impact of an incentive regime prior to its introduction, we do not believe that it is unreasonable for the incentivised party to be able to make an assessment of the potential risk/reward to which it might be exposed. Indeed, Ofgem's initial consultation on the existing interim incentive scheme included an assessment of each DN's financial target[1] from which a DN could calculate its potential exposure.

However, no such assessment is possible for the proposed transition incentive scheme due to the uncertainty over the NTS exit capacity charges that will apply for the transition years. This is because the methodology used to calculate NTS entry and exit capacity is to be reviewed as part of the forthcoming NTS price control review and recent consultations by Transco would suggest that there are likely to be significant changes in these charges going forward. Given the role of the NTS exit capacity charge within the incentive mechanism, the impact of these charge changes will have a direct impact on the risk faced by a DN under the transition incentive regime.

Although the proposed cap and collar would, to some extent, limit a DN's relative exposure under the proposed regime, it does not provide any protection against a DN's absolute exposure. Therefore, due to this charging uncertainty we believe that the proposed incentive scheme would need to include a provision that would limit a DN's absolute exposure. This could be achieved quite simply by adjusting the caps/collars to a fixed £m amount rather than a percentage of capacity "purchases". We also agree with Ofgem that both DN outturn performance and the target should be based on the prevailing prices in the year in question (and hence the DN would not be exposed per se

[1] National Grid Transco – Potential sale of gas distribution network businesses. Initial proposals on interim incentive schemes supporting the offtake arrangements. March 2005 79/05. Appendix 3.

to change in Transco's pricing methodology).

(iii) An assessment of efficiency.

In our view, Ofgem's proposed transition incentive regime has assumed that all additional offtake capacity requests are "inappropriate". We do not agree with this assumption. As we have already indicated above, we do not believe that it is appropriate to penalise a DN where there has been genuine growth in demand over and above that anticipated in the forecast, for whatever reason. However, we also fail to see how it could be considered appropriate to penalise the DN if it requests additional NTS offtake capacity in situations where this is the most efficient action to take. This is especially relevant where additional offtake capacity could be accommodated without any cost to the NTS. Indeed, the impact of such an incentive could, over time, drive DNs to become more isolated systems with as little dependence upon the NTS as possible. We would therefore regard any aspect of the scheme that simply penalised the DN for requesting extra capacity as unacceptable. As a consequence, we are firmly opposed to Ofgem's proposal that any penalty under the ARCA should not be capable of being recovered.

(iv) Interaction with ARCA

Finally, we note that Ofgem has stated that if the NTS proposals to require DNs to enter into contractual arrangements for incremental NTS offtake capacity (a DN ARCA) is implemented, any penalty payments incurred by the DN would be borne entirely by the DN. Irrespective of whether or not we support the DN ARCA proposal (which we do not), we would be extremely concerned if a situation could arise whereby a DN could potentially be exposed to a double penalty for its offtake capacity requirements, once under the licence incentive arrangements and once under the DN ARCA. In addition, the overall incentive package (including the caps/collars) will need to include any payments under the ARCA.

2. <u>Other issues</u>

In addition to the above, we have briefly responded to the other issues that Ofgem has sought respondents' views on.

(i) Reference prices.

We note that Ofgem has proposed an extension of the existing incentive regime in terms of the reference price that would be used for the transition incentive scheme. While we understand that this approach has been adopted for convenience (since currently there is no mechanism to determine a flexibility charge), in practice we believe that it could have unforeseen consequences. For example, to the extent that a DN responds to the incentive scheme as Ofgem believes it would, investment decisions associated with meeting diurnal storage requirements would be based on completely arbitrary economics. This provides another reason for removing flexibility at least from the incentive scheme for the time being.

(ii) Caps, Collars and Sharing Factors.

It is difficult to comment on these particular aspects of the proposed regime given that the target costs for the transition years are unquantifiable. Only once NTS exit charges are known will it be able to make an informed response to this aspect of the scheme. Again, this provides another reason for fixing these parameters in £m terms rather than percentages.

(iii) Incentive cost for greater than 15 days.

In view of the impending reform of the DN exit and interruption regime, we agree with Ofgem that it is not appropriate to define an incentive for this element of the scheme.

(iv) NTS incentive schemes for the transitional period.

Ofgem has proposed that it intends to defer the setting of the NTS incentives for the transitional period to the forthcoming Transmission Price Control Review. In our view, adopting this policy is unduly discriminatory against the DNs. That is because inevitably, closer to real time the more accurate the forecast is likely to be. Therefore NTS incentive targets for the transition years would be based upon more accurate forecast information when compared to the forecast information used to set the DN incentive for the same years.

Furthermore, in adopting this approach, the NTS incentive for the transition years would not be set until after any investment decisions for those years would have been made. In other words, until that stage, it would seem that Ofgem is content for the NTS to rely on planning processes and licence obligations and we therefore cannot understand why this approach could not be adopted for DNs until the enduring arrangements are introduced.

3. Conclusion

To conclude, we are most concerned that there are a number of significant issues with the proposed transition incentive arrangements that have, to date, not been addressed. In particular, no adjustment mechanism has been proposed to take account of changes in volumes of offtake capacity requirements that result from genuine unforeseen changes in demand, regulatory reform and variation in gas quality/CV. At the very least we believe that a mechanism has to be introduced address this issue. This could be achieved by either creating an incentive calculation that adjusts the *ex ante* targets or, alternatively, by making a modification to the income adjusting event provision that is currently within the licence. Furthermore, since the DN’s potential exposure to the transition is currently unquantifible, we believe a further parameter should be introduced to the incentive that would limit the DN’s absolute financial exposure.

We have also identified a number of issues with Ofgem’s methodology for calculating the target quantities for both flat and flexibility offtake capacity that would have to be addressed if Ofgem were to pursue the proposed transition incentive scheme having addressed our concerns above.

Based on these conclusions, we would urge Ofgem to postpone the extension of the interim incentives for 2008 and beyond and instead focus on the enduring arrangements as part of the NTS price control review.

For the avoidance of doubt, in the absence of an adjustment mechanism to address the issues we have identified above, SGN would not be in a position to accept Ofgem's proposals as they stand.

We would very much welcome the opportunity to discuss this response in more detail once you have had time to consider our views.

Yours sincerely

Rob McDonald
Director of Regulation