

Entry Capacity Buy Back Incentive

Ayesha Uvais
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Outline

- Objectives
- Background (last TPCR)
- Issues
- Risks going forward
- Options for next TPCR
- Questions

Objectives

- Appropriate allocation of risk
- Appropriate management of risk
- Arrangements should be simple and transparent
- Is there scope to consolidate entry and exit?

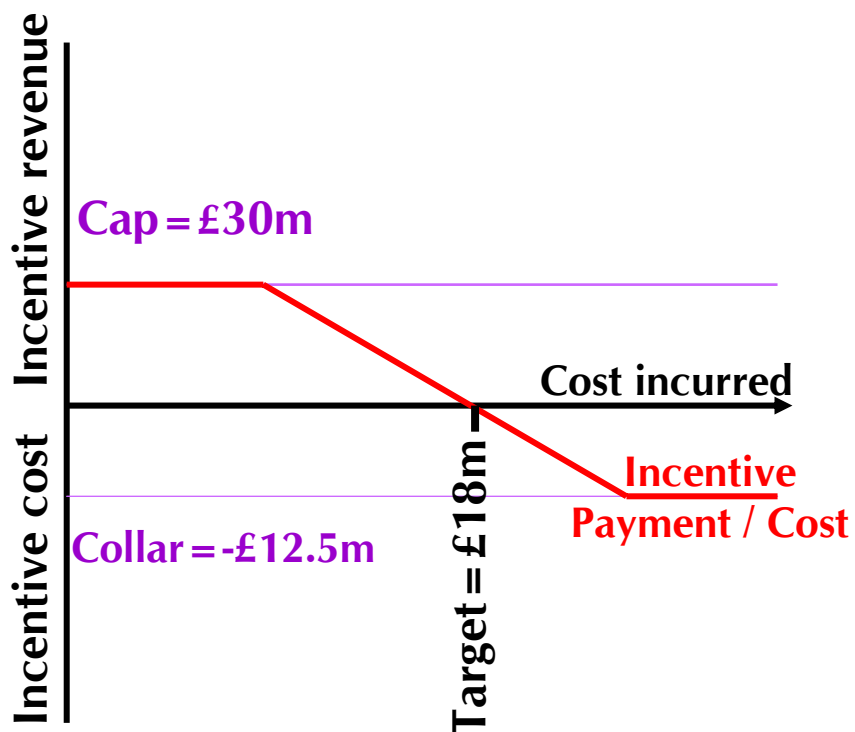
Background from last TPCR

- Investment for incremental capacity to be based on market signals (long-term entry capacity auctions) rather than long-term planning assumptions
 - National Grid Gas has discretion to constrain capacity and being subject to buy-back incentive or undertake investment
 - National Grid Gas can contract forward if it anticipates capacity to be constrained
- ⇒ National Grid Gas to make capacity available contractually but not necessarily physically

Issues

- Allocation of risk
- Opportunity costs
- Buy back market structure
- New entry terminals
- One instrument to resolve two problems

Issues (1) Allocation of risk



- Appropriate allocation of risk between
 - National Grid Gas
 - Shippers
 - Consumers

- Role of neutrality charge (potential for locational element)

- No revenue incentive on National Grid Gas once cap/ collar is hit

Issues (2) Opportunity costs

- Should buy back costs reflect opportunity costs and if so how should opportunity costs be determined?
- At present National Grid Gas required to buy back 'space' i.e. buy back unused capacity at the constrained terminal as well as the constrained capacity to resolve operational constraint
- How should modelling of buy back parameters take account of opportunity costs?

Issues (3) Buy-back market structure

- Limited evidence of contracting ahead – shippers have no obligation to sell capacity
- Limited number of shippers
- National Grid Gas could be in a distressed buyer position
- Mark up of capacity costs in buy back market

Issues (4) New entry terminals

- Limited scope for shippers to agree construction scope with National Grid Gas for new entry terminals
 - Scope for more flexible contractual arrangements
- Trade off between project timeline and costs (for example 2 year timeline with high costs, 3 year timeline lower costs, 4 year timeline low costs)
- Role of shippers in managing buy-back risk
- Are incentives on National Grid Gas sufficiently strong to ensure timely delivery of investment?

Issue (5) One instrument - two problems

- Buy back incentive currently used to address operational constraints (ST) and incremental investment (LT)
- Different levels of risk associated with operational constraints and incremental investment
- May be appropriate to provide different incentives reflecting risk and return
- How to distinguish between operational constraints and constraints due to delayed incremental investment?

Risks going forward

- Uncertainty about gas flows in next PCR period
 - Gas supply uncertainty from increasing reliance on imports rather than offshore supply (latter more predictable)
 - Link to baseline capacity at existing entry points
- Increased focus on new entry points – greater uncertainty
- Planning consent process (including environmental impact assessment)
 - Longer timeline for planning consent (approx 6 months → 6 – 12 months)
 - 12 months of data gathering for environmental impact assessment
 - Compulsory purchase orders
 - ⇒ No parallel processes but sequential
- Treatment of buy back costs arising from a catastrophic event

Broad options for next TPCR

- **Option 1:** Retain broad structure but update for underlying data
- **Option 2:** Retain broad structure but change allocation of risk between National Grid Gas, shippers and consumers to reflect increased uncertainty going forward
- **Option 3:** Different structure, for example involving non linear risk sharing linked to buy back volumes and/or reducing uncertainty through the use of contractual arrangements and/or adjustment mechanisms reflecting change in circumstances (two year review, income adjusting event)

Questions

- Should there be a distinction between buy-back due to operational constraints and buy-back due to late delivery of incremental capacity? Two different mechanisms? How to distinguish between the two constraints?
- How could consumers be most appropriately protected?
 - How should risk be allocated?
 - Should shippers face more risk? Which shippers? (neutrality charge,)
 - Should National Grid Gas face more risk?
 - Should buy-back mechanism retain current form (i.e. cap/collar, sharing factor, target level of costs)? If so, how should the parameters be set?
- Should buy back costs be capped in catastrophic events (how to define a catastrophic event)?

A large, central version of the ofgem logo, with the word "ofgem" in white lowercase letters on an orange rounded rectangular background. The background of the slide features a faded image of electrical components, including a three-pin plug and a circuit board, with the word "electricity" faintly visible in the background.

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