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Dear Mark

**Final proposals on transitional incentive schemes and formal licence  
consultation under section 23 of the Gas Act 1986 and paragraph 3(a) of  
Standard Special Condition A2**

As the transitional incentive scheme affects the transmission and distribution businesses of National Grid quite differently, each has formulated its own response. This response is on behalf of the distribution business.

Following the above consultation National Grid accept the proposed licence modifications and the formal letters of acceptance will be sent shortly.

There are two points of detail in the consultation where we believe that further consideration may be required. The first point is in relation to the cash flows under the transitional arrangements. In the description of the proposed transitional arrangements, paragraph 2.10 states that: "In addition, aside from payments made through any incentive arrangements, DNs do not bear any of the cost of NTS exit rights requested. Instead, any such costs would be borne, under the current charging arrangements, entirely by customers connected to the DNs." However, under the proposed modifications to DN Special Condition E2B, reference is made to implementing "Option 2A" (where the DN pays NTS for exit capacity) from 1<sup>st</sup> October 2008. Changing to a model where the DNs pay for NTS exit capacity would require significant alterations to DN charging systems. Given that the introduction of the enduring arrangements is likely to require further changes to the DN charging systems, we remain to be convinced that the benefits of moving to "option 2A" in the transitional arrangements outweigh the additional costs involved.

Our second point concerns the proposed DN ARCA contracts. We support the comment in paragraph 3.45 that: "Furthermore, DNs could enter into contractual arrangements with large connecting parties such that, if the connecting party does not require the capacity that it has requested, the DN is able to back off any resulting liability under the DN ARCA". However, the following example illustrates a potential problem. Large consumer A requests additional capacity at an Offtake, the DN enters into an ARCA and the NTS provide the capacity in question. However, in the meantime, large consumer B at the same Offtake closes and ceases to consume gas. There is a risk that the DN does not need to book the additional capacity requested under the ARCA, but is clearly unable to pass on the liability to consumer A, who has taken the additional gas that he requested. One solution would be to

link a DN ARCA to an increase in the consumption of gas at a specified site. Hence, provided the volume of gas is consumed at the specified site, the DN would have no liability under the ARCA. If this problem is not addressed, whenever a DN signs an ARCA, it will carry the NTS stranding risk should another consumer fed by that Offtake reduce its take of gas. The proposed solution would bring DNs in line with Direct Connect customers signing an ARCA, who only take the risk that the consumption of gas at their site does not materialise. We shall be making this point in our response to the NTS consultation on their ARCA proposal.

I trust that you find the above comments helpful in developing these incentive schemes. If you would like to discuss any of the points raised, please do not hesitate to contact me.

Yours sincerely

***By E-Mail***

Phil Lawton