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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.**

In response to the above document, please find attached our detailed comments on Ofgem's final proposals for the transitional incentive scheme for the period October 2008 to September 2010.

To summarise, SGN continues to have a number of concerns about the incentive targets that have been set for its two networks. However, we welcome Ofgem's inclusion of an absolute limit on a DN's financial exposure under the incentive scheme and the recent publication of a consultation document on the income adjusting event licence provisions. We also welcome Ofgem's recognition that the transition targets will be reassessed if and when DN interruption reform is implemented. In addition, Ofgem's comment that the extension of the interim arrangements does not set a precedent for the enduring arrangements is helpful.

While we believe the licence drafting achieves the intent of the incentive scheme, we believe it would be helpful if Ofgem could clarify how the incentive performance measure calculation for 2010/2011 will be pro-rated to apply only for the period 1st April to 30th September 2010. Finally, we have a number of concerns with NG's proposals for the transition offtake arrangements and believe that their implementation at this stage is inappropriate.

Notwithstanding the above, SGN accepts the proposed licence modifications to the licences of the Scotland Gas Network and Southern Gas Networks notified in Ofgem's formal Notice Under Section 23(3) of the Gas Act 1986 contained in Appendix 6 of

Ofgem's document "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".

We also confirm that we do not object to the modification proposal to amend the definitions within Standard Special Condition A3 as described in the Notice under Paragraph 3(a) of Standard Special Condition A2, contained in Appendix 5 of Ofgem's document final proposals document.

However, in accepting these licence modifications we would like to make it clear that our fundamental objection to the incentive scheme and the methodology for setting the targets remains. If we are to agree an acceptable incentive scheme going forward, these issues must be addressed as part of the enduring arrangements.

If you would like to discuss any of the points we have made, please give me a call.

Yours sincerely

Rob McDonald
Director of Regulation.

Scotia Gas Networks detailed response to Ofgem’s document “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”.

Thank you for the opportunity to respond to the above final proposals. In doing so we have commented on the areas that have been discussed in the following order: the final proposals for the incentive scheme; the specific licence drafting that is the subject of Ofgem’s formal notices; and finally, we comment briefly on National Grid NTS’s (NG NTS) proposals for the transition offtake arrangements.

Transition Incentive Scheme

In our response to Ofgem’s initial consultation paper on the transition incentive scheme, we raised a number of key issues. In particular, we were concerned that a DN’s exposure under the transition incentive was unquantifiable given the proposed review of NTS exit charges. Furthermore, we were concerned that a reform of the DN interruption arrangements could have a significant impact on a DN’s NTS exit capacity requirements (for both flat and flexibility capacity), as could genuine unexpected demand growth and variations in CV.

Given the above, we welcome Ofgem’s proposal to introduce an absolute limit to a DN’s exposure under the incentive scheme that would apply in conjunction with the existing cap and collar. We also note that Ofgem acknowledges that it will be necessary to consider re-opening the DN incentives to ensure that DNs are not unduly disadvantaged should the introduction of the DN interruption regime lead to a step change in DN capacity requirements. This is much welcomed and we believe that an assessment of the DNs’ capacity requirements in light of the incentive scheme should be an integral part of the DN interruption review.

Furthermore, we welcome the recent publication of Ofgem’s consultation on potential changes to the current Income Adjusting Event (IAE). In our view, the IAE should enable a DN to be recompensed where genuine unexpected demand growth and/or variations in CV beyond a DN’s control lead to financial exposures under the incentive scheme. To that end we are encouraged that Ofgem has acknowledged that changes that are beyond a DN’s control and that cause them to be at a financial disadvantage under the incentive could form an acceptable basis for a claim under the existing IAE.

We also note the more general point in paragraph 3.144 that the extension of the interim incentive will not affect the development of the enduring arrangements which, of course, may involve the reassessment of the interim/transition scheme in light of actual experience.

Nevertheless, we are most disappointed that Ofgem’s final proposals do not address our concerns in respect of the proposed specific incentive targets, for both flat and flexibility capacity. Rather, Ofgem has continued to pursue the targets that have been proposed by NG NTS, which we believe is inappropriate. While we recognise that the targets themselves do not “set” the 1 in 20 obligation, it is in our view inappropriate to set the

licence targets based on a third party's assessment of the 1 in 20 obligation when it results in the incentive scheme being weighted against the licensee.

We are also concerned that Ofgem has not accepted that the relationship between flex requirements and load growth is not linear. Ofgem has commented on this aspect of the targets but has not, in our view, adequately explained the continued use of a linear relationship when setting flex targets to take account of forecast demand growth. Again, we believe that a failure in this respect weights the incentive against the licensee.

In developing the enduring arrangements it is vital that both of these issues are addressed.

Licence Drafting

We have considered the licence drafting set out in Appendix 7 of Ofgem's final proposals and to which the notices provided in Appendices 5 and 6 relates.

1. Proposed modification to Standard Special Condition A3.

We agree that the inclusion of a new term "NTS exit flat capacity" helps clarify the existing licence drafting and therefore do not raise any objections under the private collective licence modification process.

2. Proposed modifications to Part E (Special Conditions applicable to the Licensee (DN)).

We believe that the licence drafting relating to Scotland Gas Networks and Southern Gas Networks set out in Appendix 7C(3) and 7C(4) respectively achieves the intent of Ofgem's final proposals both in terms of the incentive scheme and the proposed new definition in Standard Special Condition A3.

As Ofgem is aware, the price control year over which the incentive scheme is measured and the gas year are not aligned. Therefore, the last six months of the transition scheme (i.e. from 1 April to 30 September 2010) will need to be "pro-rated". However, the exact mechanism for doing so is not, we believe, explicit within the licence drafting and therefore we would welcome clarity from Ofgem on how this will be achieved.

We also note that Ofgem has retained the existing licence drafting that would allow the mechanism for payment flows to move to an "Option 2A" approach on 1st October 2008 (or such date that the Authority shall otherwise direct in writing). Clearly, a move to the "Option 2A" approach would have significant implications for the DNs in terms of charging methodologies, setting charges and the associated system changes. To the extent that DNs incur costs in implementing this change these would need to be allowed for within the price control. In our view, the Option 2A approach was discussed in the context of the enduring arrangements and therefore we believe that it should not be implemented before those arrangements have been finalised. However, given the issues associated with a move to that approach we would welcome Ofgem's early determination on this issue.

3. NTS Licence Changes

We have considered the proposed changes to the Special Condition C18. In effect, Ofgem has proposed that baseline offtake capacities (both flat and flex) for each offtake point for the transition **gas** years (gas year 08/09 and 09/10) are contained in the IExCR methodology statement. This would seem a pragmatic approach. The numbers that have been presented by Ofgem in Annex 1 of the consultation paper would appear to have been calculated in the same way as the licence incentive targets. Therefore, although we do not agree with the numbers, we understand how they have been derived.

Proposed Offtake Arrangements

Ofgem has described the NTS offtake arrangements (ie the DN ARCA) that are the subject of a concurrent NG NTS consultation and in doing so, it appears that Ofgem has accepted their implementation as an integral part of the incentive regime.

While the overall concept of the proposed arrangements may be considered by Ofgem as appropriate, in our view, the detail of the current proposals are not. We will provide a more detailed response to the NG NTS IExCR consultation which we will copy to Ofgem at that time. However, our main concerns are:

- Under the current proposal, the DNs would bear all of the NTS capital investment risk at the offtake. In our view, this issue is an integral part of the enduring arrangements discussions and, therefore, the implementation of this shift change of risk should not be considered ahead of the enduring offtake arrangements;
- If implemented, a DN ARCA that is entered into within the transition period would still be “live” at the time the enduring arrangements are introduced. The issue of how the two potentially different arrangements would run concurrently does not appear to have been given any consideration;
- We do not agree with Ofgem that the proposed DN ARCAs are “normal” commercial contracts and therefore to the extent issues arise they should be resolved through the courts. DN ARCA is a NTS-driven contracts that the DNs have little or no power to negotiate. Indeed, this is clearly illustrated by the current consultation process;
- Under the proposed DN ARCA, the NTS can delay the delivery of incremental offtake capacity at its own will and without proportionate compensation to the DN and with disregard to the impact that would have on the DN’s security of supply statutory obligations;
- To the extent that the NTS has underestimated the cost of any specific reinforcement that triggered the DN ARCA it can impose additional costs and (therefore) change the length of the ARCA period at any time once the agreement has been signed;
- The NTS proposed DN ARCA threshold is, in our view, inappropriate.

For these reasons we would urge Ofgem to reject the recent changes proposed by NG NTS to the IExCR methodology, the SC4B Statement and the DN ARCA until the enduring arrangements have been developed.