

Associate Director, Transmission

National Grid House Warwick Technology Park Gallows Hill, Warwick CV34 6DA

Chris Bennett Transmission Regulation Manager

chris.bennett@uk.ngrid.com Direct tel +44 (0)1926 655949 Direct fax +44 (0)1926 656520

www.nationalgrid.com

28 April 2006

Colin Sausman

Ofaem

London

9 Millbank

SW1P 3GE

Dear Colin

Adjusting National Grid's Revenue Allowances When Large New Entry Points Connect to the Gas Transmission System

We welcome the opportunity to respond to Ofgem's consultation on adjusting National Grid's revenue allowances when large new entry points connect to the gas transmission system. This response is written on behalf of National Grid Gas (NGG) NTS and all references in this response to NGG should be construed as being to NGG NTS.

Our main comments relate to the principles behind the setting of Unit Cost Allowances (UCAs), which drive the more detailed aspects on which Ofgem is consulting. Detailed answers to the specific questions in the consultation document are given in the appendix to this response.

In its May 2005 consultation¹, Ofgem identified five draft principles for setting UCAs. In our response dated 30 June 2005, we supported these principles and suggested that a sixth should be added, which we believe is also fundamental to the process. The principles proposed by Ofgem were that:

- UCAs should be set in a timely way so not to frustrate the legitimate expectations of project developers;
- UCAs should reflect long-term costs, be non-discriminatory and facilitate competition between shippers and suppliers;
- UCAs should not create perverse incentives, including for the uneconomic bypass of NGG's network;
- UCAs should be set via a transparent process and informed by consultation and expert advice; and
- For the next price control NGG should be responsible for setting UCAs for the purpose of setting auction reserve prices (consistent with the approach used with other network operators where the licensee sets prices and Ofgem approves any changes to the underlying methodology).

The additional principle that we proposed was that:

¹ Gas Transmission – new NTS entry points, reserve prices in auctions and unit cost allowances (UCAs), May 2005 (ref 139/05)

 UCAs should provide sufficient incremental revenue to cover the costs incurred by NGG in providing incremental capacity.

We are pleased to note that Ofgem has agreed with this sixth principle and made reference to it within paragraph 3.4 of the consultation document.

In the explanatory note to its section 23 notice in August 2005², Ofgem recognised that the setting of UCAs for large new entry points (LNEPs) could not be satisfactorily addressed through either of the options put forward in the May 2005 consultation. We note that Ofgem is seeking to address this issue through this consultation for 2006/07 and separately through the Transmission Price Control Review (TPCR) for 2007/08 onwards.

Currently, UCAs have a dual role and our comments relate to these two aspects:

- (a) setting additional revenue for NGG for providing incremental entry capacity; and
- (b) setting the reserve price for entry capacity auctions.

Ofgem has indicated that it believes it is not appropriate for UCAs to continue to act as auction reserve prices and discussions with the industry are already under way through the Gas Transmission Charging Methodology forum (TCMF) to develop a suitable methodology for setting entry capacity auction reserve prices, to be in place for the next price control. Therefore, we anticipate that from April 2007 UCAs will act only as revenue drivers for NGG. However, the UCAs for LNEPs covered by this consultation will continue to perform the dual role of revenue drivers and auction reserve prices during 2006/07. Therefore, in order to meet the timescales for the September auctions, the UCAs need to be set in June/July.

Revenue

We note Ofgem's statement in paragraph 3.4 of the consultation document that UCAs should provide NGG with a reasonable prospect of recovering the network reinforcement costs associated with accommodating the new entry point. We believe, therefore, that in order to achieve this it is critical that UCAs should be reflective of the costs reasonably likely to be incurred in providing incremental entry capacity.

The current context of changing and evolving supply patterns presents a significant challenge to achieving ex-ante cost-reflectivity, which is in turn determined by the way that the network is modelled. This includes, but is not limited to, the supply scenario(s) used, the base network chosen, the approach adopted for network balancing and the method of apportioning costs between entry and exit. To the extent that the model used in determining the UCAs is based on an 'average' scenario, this will result in a risk that we will not recover sufficient revenue to cover our investment costs in certain 'worse than average' circumstances.

In the event that Ofgem, as a result of this consultation, were minded to set UCAs below the ex-ante best estimate of costs, we would want to ensure, through discussions with Ofgem, that NGG was not exposed to a revenue shortfall through setting non cost-reflective UCAs in advance of the next price control. In addition, given the timescales associated with setting the UCAs (in order to hold auctions in September), it may be necessary to reserve the right to review the UCAs again as part of the price control process.

² Section 23 notice to modify Transco's Gas Transporter licence: Explanatory note to accompany proposals for new entry points to Transco's National Transmission System, August 2005.

Pricing

Consistent with our response to the May 2005 consultation we believe that there may be perverse incentives on certain customers to lock into long-term capacity rights if the UCAs at LNEPs (and therefore the auction reserve prices) are set at levels below the true cost-reflective values for 2006/07. As Ofgem notes in paragraph 2.14, such non cost-reflective UCAs could also ultimately lead to incorrect investment signals for network reinforcement, resulting in:

- (a) insufficient revenue and a risk of reopening the price control; and
- (b) a risk of building stranded assets.

We believe, therefore, that this supports the argument that UCAs should also be costreflective with respect to reserve prices. However, we acknowledge that there are likely to be concerns within the industry about how UCAs for LNEPs should be set for the 2006 LTSEC auction and recognise that different parties will consider some principles to be more important than others, including, but not necessarily limited to, the other factors outlined in chapter 5 of the consultation document, namely:

- (a) the relationship to existing UCAs and charging regime;
- (b) non-discrimination;
- (c) Milford Haven precedent; and
- (d) differential treatment of storage sites.

In the event that Ofgem, as a result of this consultation, were minded to set UCAs below the ex-ante best estimate of costs, we would be seeking comfort from Ofgem that this approach was not inconsistent with NGG's licence obligations relating to the setting of reserve prices under Standard Special Condition A5 (5)(aa)(ii)(I), i.e. the "relevant methodology objectives", and the related obligations in Standard Special Condition A5 (1) and (3), should there be insufficient time to seek amendment to our transportation charging methodology.

Conclusion

In summary, we believe that the overriding principles that should be used for setting UCAs for LNEPs are those of revenue recovery and cost-reflectivity. However, in light of the above discussion, we suggest that any UCAs set for revenue purposes for LNEPs this year (following the outcome of this consultation) should be further reviewed to ensure consistency with the process still to be agreed as part of the TPCR for recalculating all UCAs.

However, in the event that Ofgem were minded to set UCAs below the ex-ante best estimate of costs, we would seek assurances from Ofgem in regard to the implications of non cost-reflective UCAs on our revenue and on our licence obligations with regard to pricing, the details of which are discussed above.

I would be happy to discuss any elements of the response with you or members of your team.

Yours sincerely, By email Chris Bennett

Appendix – Answers to questions posed in Ofgem's consultation document

CHAPTER 3

Question 1

Do you agree with the proposed scope of this consultation as set out in this chapter, ie covering network modelling issues and the identification of other potentially relevant information?

We support Ofgem's issuing of this consultation to seek industry views on how UCAs should be set such that an auction for LNEPs could be held as soon as practicably possible in order to allow developers to secure NTS entry capacity. We agree with the proposed scope of this consultation. However, we would note that, in order to meet the timescales for the September auctions, the UCAs need to be set in June/July.

Question 2

Do you agree with the proposed focus on estimating actual long-run incremental costs, for the purpose of setting UCAs for large new entry points?

We agree with the approach proposed by Ofgem that UCAs for LNEPs should be based on estimated long run incremental costs. However, we recognise that these cost estimates are very dependent on the modelling approach taken and the inputs used for that model. These inputs are in turn very dependent on, inter alia, the supply and demand scenarios chosen.

CHAPTER 4

Question 1

Do you agree that it might be appropriate to model the "Auctions+" supply scenario and 1 in 20 winter peak demand scenario taken from NGG's latest Ten Year Statement, or would it be more appropriate to consider, in addition to or instead of these scenarios, other potential supply and demand scenarios?

Under our licence obligations we are required to release all entry capacity up to the baseline capacity at each existing entry point. The "Auctions +" supply scenario supplements entry capacity auction investment signals with data obtained through the Transporting Britain's Energy (TBE) process and may offer an appropriate supply scenario for network modelling in certain circumstances. However, the other scenarios mentioned ("Transit UK" and "Global LNG") may be more appropriate in other circumstances.

The TBE review is currently ongoing and we expect that, following its conclusion, we will be developing a central supply scenario in June. This scenario will include some sensitivity analysis, which we believe to be an essential element of the modelling, given the uncertainty of future gas flows.

We support the use of the 1 in 20 winter peak demand scenario, which is consistent with our licence obligations.

Question 2

Do you agree with the proposed approach to setting the base network, including the proposal to use the same base network (ie, for 2008/09) for all new entrants irrespective of when their project is expected to come on-stream?

We believe that it is appropriate to use the same base network for assessing the UCAs for all large new entry points. We support Ofgem's proposal to use the 2008/09 network as the base case on the assumption that we receive the necessary funding through the price control to develop the physical network to this state.

However, it should be noted that, whilst the costs for providing incremental capacity on the system at a particular entry point will depend on the existing supplies assumed in the base case, they may also be affected by other potential entry points seeking entry capacity at the same time. We believe, therefore, that the order in which developers of new sites request UCAs could significantly influence the marginal costs calculated.

Question 3

Do you have any views on the range or combination of years that the network should be modelled for, given that with the Graphical Falcon model a multi-year modelling period (eg, 10 years or more) is unlikely to be practical, given the difficulty of producing robust long term gas flow forecasts, and given that forecasting for later years (when the new entry capacity is assumed to have come on-stream) may involve a circularity problem?

We have committed to development of the network up to 2008/09 and this therefore presents the latest stable network on which to do analysis. Network models beyond that date will of necessity be less certain, and we therefore believe that the network should be modelled only for 2008/09 when calculating the UCAs for application in auctions from 2006/07.

We have been working with Ofgem to provide analysis to inform the setting of suitable revenue drivers for the forthcoming price control period as part of the TPCR; this analysis has been based on the 2008/09 network. We therefore believe this may be an appropriate way forward for the setting of UCAs for LNEPs.

Question 4

Do you agree that it is appropriate to determine ranges of flow increments for each large new entry point (eg, 20-40 mcm/d, 40-60 mcm/d, 60-80 mcm/d), based on the incremental flow requests submitted by the applicant, and then set a separate UCA for each range? Also, do you agree that if the final capacity bookings signalled in the auctions are in excess of the chosen ranges, a new UCA request will have to be submitted?

We support the use of ranges of flow increments, each with a separate UCA for determining revenue drivers. We also agree that, should the final capacity bookings be outside the set ranges, a new UCA request should be submitted.

Whilst this addresses our concerns regarding revenue recovery, the consultation document does not indicate how the appropriate UCA would be determined to apply in the NPV test to trigger the release of incremental capacity. We are therefore concerned that, depending on how this is chosen, there could remain a perverse incentive on shippers to overstate their projected gas flows in order to set a low UCA for the NPV test and then to bid for less capacity than originally stated.

Question 5

Do you agree that it may be appropriate to treat the costs of connecting pipelines differently from other network reinforcement costs incurred to accommodate large new entry points, and if so, how?

We support the idea of treating the costs of connecting pipelines differently from other network reinforcement costs. We believe that the construction of such pipelines should be treated as a contestable service, given that there are opportunities for the work to be open to competition, including construction by the developer of the new entry point, and we believe it should therefore be excluded from the price control. However, we believe it is appropriate that, if the connecting pipeline is under the ownership of NGG, it should at some point enter the RAV. If a connecting pipeline owned by a third party were to be adopted into the NTS in these circumstances, then we would need to ensure that it had been constructed and maintained to the appropriate standards.

This may be something for consideration as part of the TPCR and we look forward to working with Ofgem to develop any future proposals in regard to the treatment of connecting pipelines.

Question 6

Do you agree that cost allocation between entry and offtake should depend on the approach by which the network is balanced and, if so, that costs should be apportioned fully to entry points if a supply substitution approach is adopted?

We agree that the allocation of costs for revenue drivers should depend on the choice of approach for network balancing. For example, supply substitution for the purposes of discovering the unit costs for large incremental flows implies that all costs should be included in the UCA for the relevant entry point. However, we believe that this assertion does not necessarily hold for marginal cost calculations for discovering the price of capacity; we believe that the 50/50 split used within the LRMC methodology remains appropriate as it is consistent with the modelling of route costs where equal entry and exit flow increases are considered. In any case, an appropriate balance needs to be struck between the party triggering the investment and all users for whom security of supply is improved as a result.

We are already working with Ofgem and the industry through the Gas TCMF to consider the appropriate allocation of costs for pricing.

Question 7

Do you agree that it is appropriate to use supply substitution for network balancing purposes, in the context of modelling incremental flows at large new entry points, or are there situations in which a load absorption approach may be more appropriate? If we adopt supply substitution, which of the proposed four options would you consider the most appropriate, and on what grounds? Alternatively, would you consider another approach to supply substitution more appropriate, and if so, on what grounds?

We have provided information to Ofgem using supply substitution, load absorption and hybrid approaches to network balancing as part of ongoing work with Ofgem as part of the TPCR. We agree with Ofgem, that the most realistic (and therefore most cost-reflective) approach is supply substitution, though the approach might be perceived to suffer from a degree of subjectivity in determining which are the most suitable supplies to be 'turned down' to keep supply and demand in balance.

We believe that the option of load absorption is inappropriate as it would be expected to generate exit-related costs. These could only be accurately removed from the process using engineering judgement which might be regarded as subjective and non-transparent. We therefore believe that this would rule out both the load absorption and hybrid approaches.

Of the alternative supply substitution approaches suggested, scaling all supplies would lead to understated costs due to the interactions between entry points, and excluding those entry points less than 50km from the new entry point might not overcome this problem. Some entry points that are close in proximity have little impact on each other due to being connected on different sides of local compressors or different feeders whereas some entry points that are separated by distances greater than 50km share common feeders and compressors and hence are interrelated. An alternative supply substitution approach could be based on the commercial order in which shippers might use supplies to balance demand. Experience indicates that the order in which supplies are used to match demand is typically beach gas first, then a combination of long range storage, Interconnector and LNG importation followed by mid range storage and LNG only at the highest demands. This order could be used in reverse taking into account the 'least helpful' supplies within a category first.

Notwithstanding this, we believe that scaling the supplies that have the least impact on capacity for the new entry point would be the most appropriate approach to take. Any move away from this 'worst case' approach introduces a risk that we will not recover sufficient revenue. For example, work undertaken on a potential large new entry point has indicated that investment costs can vary in excess of several hundreds of millions of pounds depending upon the underlying supply and demand assumptions.

We are keen to continue discussions with Ofgem on the most suitable approach to take in order to set cost-reflective revenue drivers. We also look forward to working with Ofgem to consider the implications of the risks introduced by a network balancing approach that differs from our preferred 'worst case' approach.

Question 8

Do you have any views on what cost data should be used in the modelling work, eg should cost data from the last price control be used (for consistency reasons) or should more up-todate cost data be used (to improve cost-reflectivity)?

We support the use of up-to-date cost data in modelling for revenue purposes, consistent with the proposed Investment Cost Methodology included in the review of Incremental Entry Capacity Release Methodology Statement, issued to the industry by the Joint Office of Gas Transporters for consultation on 6th April 2006, though we recognise that this could lead to higher charges for LNEPs compared to existing entry points.

CHAPTER 5

Question 1

Should Ofgem take into account any of the factors raised in this chapter when setting UCAs for large new entry points, and if so, on what grounds and in what way?

Whilst we believe that UCAs should be calculated using the most up-to-date information, we anticipate that certain users may raise concerns over the potential discrimination between existing UCAs and those calculated for LNEPs. This concern is likely to arise from the fact that, as Ofgem itself notes in paragraph 2.7, there had already been significant changes in gas flow patterns and an increase in the costs of network reinforcement by the time it consulted in May 2005. We reiterate our concern that, if UCAs are set below the ex-ante best estimate of costs, there is a significant risk that we will be exposed to a revenue shortfall.

Question 2

Are there any other factors, not mentioned in this chapter, that Ofgem should take into account when setting UCAs for large new entry points, and if so, on what grounds and in what way?

There are two additional factors that we would draw to Ofgem's attention.

First, as we indicated in our response to the May 2005 consultation, in the event that Ofgem is minded to set UCAs below the true cost-reflective level, there is a risk that we would be exposed to a revenue shortfall. Associated with this is the question over whether Ofgem, by setting non cost-reflective UCAs, would put NGG in a position of not being able to meet its licence obligation (Standard Special Condition A5 (5)(aa)(ii)(I)) to set cost-reflective auction reserve prices. This latter point would only be relevant if there were insufficient time to seek amendment to our transportation charging methodology.

Second, whilst we support the principle of developing cost-reflective UCAs, we are mindful of the fact that this consultation is running in parallel with a more general review of UCAs as part of the TPCR. We may, therefore, need to review the UCAs set as part of this process to ensure consistency with the process still to be agreed as part of the TPCR process for recalculating all UCAs.