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Dear Colin

Adjusting National Grid's revenue allowance when large new entry points connect to the gas transmission system.

In publishing the above consultation, Ofgem is seeking views on how it should set revenue allowances for additional work that National Grid Gas (NGG) might need to undertake in order to accommodate large new entry points onto the National Transmission System (NTS). We understand that this may be necessary given the structure of NGG's existing price control, and we have therefore provided our comments on the specific questions raised in the attached appendix. However, in our view, this consultation is not just limited to how to set NGG's revenue allowances. It implicitly endorses the application of a long run incremental cost (LRIC) charging methodology which we believe raises many issues and therefore, it is this aspect of the current arrangements that we have discussed in more detail below.

As Ofgem has described, at the time of the last price control review, entry point specific Unit Cost Allowances (UCAs) were introduced for each existing entry point to the NTS based on a LRIC methodology. Under the current price control, the UCA has two functions. First, it acts as a revenue driver for the provision of incremental entry capacity and second, it is used by NGG to set reserve prices to recover allowed revenue for existing entry capacity. As we explain below, it is this second aspect of the UCA that causes us particular concern.

In essence, we fundamentally disagree with LRIC charging methodologies and have written to Ofgem on their application in the context of network charging on a number of occasions, most recently in a letter addressed to Mark Cox dated 24th February 2006. In our view, these models bring volatility and instability to individual customers as charges are driven by the decisions of other parties connected to the network. The models are also extremely sensitive to precise assumptions used to build up the charges. There are also a large number of plausible ways of constructing the charging model and there is no

"right" answer. This, coupled with the sensitivity of the output to the assumptions used, in our view, means that the use of a LRIC model to set charges is flawed.

Experience to date of the entry point UCAs illustrates the above concerns. In May last year, Ofgem identified that since setting the UCAs at the time of the last price control review (only three years previously), there had been significant changes in gas flow patterns which implied changes in the LRICs and, therefore, large variations between the proposed new UCAs when compared to the existing UCAs. In other words, the forecast supply and demand scenarios and associated assumptions that were used in the LRIC model when setting the UCAs were now deemed to be wrong.

Ofgem's May 2005 consultation paper also highlighted that there have been inconsistencies in the way in which the UCAs have been set within the three year period. The consequence of these findings is that there is a considerable risk that NTS entry capacity UCAs and therefore capacity charges will be "rebalanced" to reflect the change in assumptions as well as variations to the LRIC methodology applied. Certainly, NGG's analysis last year showed that the impact of the proposed rebalance would be significant with extreme movements in UCA at some entry points to the system. It is therefore clear that the use of a LRIC model introduces considerable instability and uncertainty to the transportation charging regime. It is also clear that to the extent the UCAs have been used as revenue drivers, NGG will have faced perverse incentives to over or under invest in certain parts of the network.

We therefore believe that going forward, network charges should not be based on the outputs of a highly subjective LRIC charging methodology. Rather, they should be based on the allocation of actual costs associated with the existing network. We believe that this approach would certainly be more cost reflective than basing them upon notional changes to a forecast of future cost.

These points notwithstanding, we have attached a more detailed response to the questions raised in the consultation.

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

Yours sincerely

Rob McDonald
Director of Regulation

Appendix

Response to specific questions raised

Chapter 3.

We note that the scope of Ofgem's consultation is limited to network modelling issues and the identification of other potentially relevant information. While this may be relevant for the immediate issue of how to set UCAs for the period until the start of the next price control period, we nevertheless believe that wider consideration should be given to the application of LRIC modelling when associated with charging methodologies.

Chapter 4.

Q1

In addition to the proposed scenario the following scenarios should also be tested:

Supply:
Transit UK & Global LNG as there is an equal probability that these scenarios may transpire.

Demand:
The 1in 20 demands appear high. The recent winter demonstrated that when the Composite weather variable (CWV) was low the level of demand did not approach the forecast cold demand level but was close to the forecast normal demand level. This reflects demand management on the network and increasing price demand elasticity, even at domestic level.

By examining summer demand, the range of flows on the network can be investigated. SSE agree that 1 in 20 peak and summer demands should be used as scenarios.

Discussions at the Gas TCMF have suggested that more accuracy and hence cost reflectivity can be achieved by forecasting for a shorter period than the above 10-year supply & demand forecasts. The effect of a 5-year or shorter forecast horizon should be investigated. The benefits of greater cost reflectivity will however be countered by less price stability.

Q2

We do not agree with using the same base network for all investments irrespective of when the project is due on stream. Future assessments should use the best information possible. Therefore, if for a later forecast year an investment has been firmly signalled this investment should then be included in the baseline for future years.

Q3

The modelling Horizon should be constrained from between 1 & 5 years. Any further and too many potential inaccuracies are introduced. We agree with the potential risk of circularity problem where forecasts are based on previous forecasts over long forecast timescales.

Q4

We agree that it is appropriate to determine ranges of flow capacity, each of which becomes a separate UCA and that if a flow is signalled in excess of the top range a new UCA request should be submitted.

Q5

The connecting pipeline cost should be treated separately to the reinforcement costs to enable contestable services in the construction of the connecting pipeline. This may potentially lower costs and result in a lower UCA. We agree that this should only be allowed if there is only one user. If other users are likely to benefit then all costs, both connecting & reinforcement pipelines, should be included in the UCA.

Q6 & Q7

Agree that cost allocation between entry & exit should depend on the approach by which the network is balanced. If supply substitution is used then all costs should be allocated to entry. However, the transit UK & LNG supply scenarios are equally as valid as the auction supply scenario. Also, the appropriateness of a load absorption model should be compared with a supply substitution model for all of these scenarios to test the range of results.

Of the 4 supply substitution methodologies the second is preferred. This is because it is claimed to be the most realistic. The third method is considered to generate excessive investment and higher reinforcement cost may lead to an "oversized " network. The fourth method is subject to high subjectivity and potential lack of transparency. The first method would appear to be mechanistic and not reflective of the network. However, it might be useful to model all 4 methodology's in order to understand the spread in costs that are derived, at least this way the potential variance of choosing a particular methodology can be understood.

Q8

We agree that cost reflectivity is important & that the most up to date prices should be used.

Chapter 5.

Ofgem has identified a number of relevant issues that arise from the need to set new UCAs within the current price control period given their role within the charging regime and their derivation from a LRIC methodology. In our view, this further illustrates the need by Ofgem to fundamentally reconsider the role of these models in setting network charges going forward. Notwithstanding this, we have commented on the other factors Ofgem has raised below.

Relationship to UCAs for existing entry points. SSE agree that UCAs for new entry points should be set on a cost reflective basis and that the most up to date information should be used. This may well lead to different UCA's for existing & new entry points. The proposed "sensitivity" test should be undertaken to establish if the differences are material or not.

Non-discrimination. Clearly it would be inappropriate to use out of date information we therefore agree that the best possible information & models should be used to estimate new UCA's and we agree that approach would be consistent with non-discrimination.

The precedent of Milford Haven. There should be no precedent set by the way UCA's were set for Milford Haven. The process for determining new entry points by an auction is overly complicated and unnecessary. A more transparent and less complicated method would be to allow bi-lateral negotiations between the developer and NGG about the capacity and date of any new entry point. The proposed cost and user commitment could then be consented or otherwise by the authority.

Different treatment of storage sites (and other "strategic investment"). SSE strongly believes that storage sites should be treated differently from other entry points, which are likely to be LNG or interconnector supplied. This is because gas withdrawn from storage and entered into the NBP comes from gas that has already been entered into the UK NBP and injected into storage. Furthermore, the very nature of a storage site means that it is subject to both the NTS entry and NTS exit regimes, the two of which are inextricably linked making them unique when compared to other entry points. Indeed, Ofgem has an outstanding action to consider the interactions of the two regimes in relation to storage points.

We are extremely concerned that the complexity of the entry arrangements, the volatility of LRIC derived UCAs and the impact of the reform on the NTS exit arrangements will, we believe, have a significant impact on storage sites going forward. The UK has a requirement for more gas storage and barriers to new entry should be reduced not created.

Storage is strategically more important than LNG import terminals because once the gas is in store it is within the control of the UK through monitor levels. It does not rely on having the highest of all global prices to ensure delivery (as does LNG). Nor does it rely on interconnectors being filled at times of system stress when other countries might not be inclined to export.

The number of potential storage sites that are physically suitable and that are economically viable are finite in number. SSE would be interested to see what evidence there is to support the view that different treatment might increase the potential for stranded assets.