National Grid response to the proposed incentive arrangements for the provision of NTS Entry Capacity at Milford Haven

Executive Summary

We welcome the opportunity to respond to Ofgem's consultation on proposed incentive arrangements for the provision of NTS entry capacity at Milford Haven. This response is written on behalf of National Grid Gas plc in its capacity as the holder of a gas transporter licence in respect of the National Transmission System ("National Grid Gas NTS")

Before responding to the issues contained in the consultation document, we want to make it clear that National Grid Gas NTS remains fully committed, either with or without financial incentives, to delivering the network investment required in relation to gas transmission entry capacity release at Milford Haven in a timely and efficient manner in accordance with our existing licence and statutory duties.

We recognise, however, Ofgem's desire to strengthen the financial incentives on National Grid Gas NTS to deliver the capacity in a timely manner, given both the strategic importance and scale of the Milford Haven project. We also recognise that although the issue of incentives relating to new entry points is being considered as part of the Transmission Price Control, the timing of the Milford Haven investment may warrant a scheme being agreed in advance of the price control proposals being finalised.

As a matter of principle we continue to believe in and support the use of appropriate financial incentives. We believe that financial incentives should provide an appropriate balance of risk and reward that aligns the interests of the transmission company with those of consumers. As such in relation to the proposed incentive arrangements for Milford Haven, we would consider accepting financial incentives provided that:

- They are based on activities that are substantially within National Grid Gas NTS' control (such as construction activities). Other factors outside of our control (such as the timing of necessary consents being granted) should be excluded from the incentive scheme; and
- Any incentives are consistent with the overall returns being made on the Milford Haven investment.

These two elements are considered in turn below:

<u>Exclusions from the incentive scheme</u>

In relation to the proposed incentive arrangements at Milford Haven, we believe that we should only be incentivised on those elements of the project to deliver entry capacity that are within our control. We therefore believe that any incentives relating to the delivery of the Milford Haven project should **exclude** factors that are outside of our control. These exclusions should cover late delivery of consents and easements (ie EIA consent for pipelines and planning permissions for AGIs), adverse weather impacting on the ability to access land and proceed with construction and force majure or exceptional type events. We also believe that further work would be required to fully incorporate these exclusions into any incentive scheme.

The overarching principle, however, should be that National Grid Gas NTS would only be exposed financially under the incentive scheme once it had exceeded a deemed efficient period for undertaking the construction works. In practice this would mean that if late consents, onerous conditions associated with consents, or adverse weather meant National Grid Gas NTS had insufficient time to deliver the investment in accordance with the programme of works by the end of October 2007, then financial exposure under the scheme should not materialise until March 2008 at the earliest (recognising construction is not feasible over the winter months).

Consistency of incentive arrangements with rate of return

We also believe that any new incentives for Milford Haven should be consistent with the overall returns being made by National Grid Gas NTS on the Milford Haven investments. In considering whether to accept any proposed incentive scheme we would take into account the allowances being made for the Milford Haven investments as part of the transmission price control.

A further area for consideration relates to the:

Implementation of any new arrangements

Given the ongoing discussions as part of the price control review, consideration will need to be given to the timing of the implementation of any proposed incentive scheme. We would propose that any formal licence changes and subsequent changes to other documents such as the Uniform Network Code should be undertaken in parallel with other changes to those documents which result from the transmission price control process.

Question 1

Should new incentive arrangements for National Grid Gas NTS be developed in relation to the delivery of gas transmission capacity for Milford Haven?

Within the gas transporter licence held by National Grid Gas plc in respect of the National Transmission System (NTS), the present capacity buyback incentive captures the costs incurred by National Grid Gas NTS, where National Grid Gas NTS is unable to deliver entry capacity which has been sold and which shippers are intending to flow gas against. When the present incentive targets were established, these were set based on modelling of potential constraints at existing entry points on the NTS. The target was established by taking into account system capability throughout the year and comparing this with likely supply patterns. We therefore believe that the present buyback target was not set with reference to any new entry points and therefore only reflected the risks associated with operational buybacks at existing entry points.

The existing price control is set to cover the period until 31 March 2007. From the 1 April 2007 onwards, as part of the main Transmission Price Control Review, we will be working with Ofgem to agree new incentive parameters to apply from 1 April 2007. We therefore believe that until agreement of these new arrangements to apply from 1 April 2007, there is no settled position with regards to buyback incentive parameters to apply.

We agree with Ofgem's view expressed within the third Transmission Price Control consultation that an area for consideration is the reform of the current gas entry regime. We believe that it is important to ensure that mechanisms are established to deal with late delivery of capacity by the establishment of a separate buyback pot or compensation rate, contingent on planning consents being agreed as well as excluding delays that are beyond the control of the transmission company.

Having recognised the interaction with the ongoing price control discussions we can nevertheless understand Ofgem's desire to strengthen the financial incentives on National Grid Gas NTS to deliver the capacity in a timely manner. We are therefore prepared to consider accepting financial incentives provided that:

- They are based on activities that are substantially within National Grid Gas NTS' control (such as construction activities). Other factors outside of our control (such as the timing of necessary consents being granted) should be excluded from the incentive scheme; and
- Any incentives are consistent with the overall returns being made on the Milford Haven investment.

<u>Exclusions from the incentive scheme</u>

In relation to the proposed incentive arrangements at Milford Haven, we believe that we should only be incentivised on those elements of the project to deliver entry capacity that are within our control. We therefore believe that any incentives relating to the delivery of the Milford Haven project should **exclude** factors that are outside of our control. These exclusions should cover late delivery of consents and easements (ie EIA consent for pipelines and planning permissions for AGIs), adverse weather impacting on the ability to access land and proceed with construction, and force majure or exceptional type events.

Further work would be required to fully incorporate these exclusions into any incentive scheme. The overarching principle, however, should be that National Grid Gas NTS would only be exposed financially under the incentive scheme once it had exceeded a deemed efficient period for undertaking the construction works. In practice this would mean that if late consents or adverse weather meant National Grid Gas NTS had insufficient time to deliver the investment in accordance with the programme of works by the end of October 2007, then we should not be financially exposed under the scheme until at least the earliest March 2008 (recognising construction is not feasible between November and February).

<u>Consistency of incentive arrangements with rate of return</u>

We also believe that any new incentives for Milford Haven should be consistent with the overall returns being made by National Grid Gas NTS on the Milford Haven investments. In considering whether to accept any proposed incentive scheme we would take into account the allowances being made for the Milford Haven investments as part of the transmission price control.

Question 2

Are the principles identified in paragraph 4.3 an appropriate basis for new incentive arrangements

We note that within the consultation, Ofgem has identified a number of principles in relation to any new incentive arrangements and these are set out below:

1) Protect consumers from meeting costs that have arisen because of inefficiency or are above the level consistent with the operation of a reasonable efficient gas transmission system.
2) Encourage National Grid Gas NTS to deliver additional NTS capacity in a timely and cost effective manner (i.e. taking account of both its investment costs and the economic costs of disruption to the LNG supply chains)
3) Protect National Grid Gas NTS from risks that might have the effect of unduly increasing its overall business risk and cost of capital, and
4) Be consistent with a stable regulatory framework that promotes investment in the gas supply chain, including LNG import facilities. If National Grid Gas NTS is unable to meet its contractual commitments for the provision of firm NTS entry capacity and where interruptions lead to substantial costs for shippers that cannot be mitigated, then it will be important to recognise that it might be appropriate that compensation should be greater than a simple refund of transportation charges

We believe that these principles are sound and form a good basis for new incentive arrangements.

We can see merit in each of the principles set out above, however in particular we believe that principle (3) "*Protect National Grid Gas NTS from risks that might have the effect of unduly increasing its overall business risk and cost of capital"* will be critical to our ability to accept of any financial incentives in relation to Milford Haven. The expected rates of return on the Milford Haven investment coupled with any decisions on the elements to be excluded from the incentive arrangements will be key to our acceptance of any incentive scheme.

In relation to the issue of the appropriateness of compensation (principle 4), we are supportive of Ofgem's initial views expressed within the "Transmission Price Control Review 2007-2012: Third Consultation document on this issue." We therefore assume that the commercial compensation arrangements, within the Uniform Network Code, will have to be reviewed at the same time as the incentive arrangements discussion that are taking place as part of the Price Control in order to ensure a consistent approach. In the meantime we recognise that the default position for compensation is set out and managed within the Uniform Network Code.

Question 3

Should National Grid Gas NTS's exposure to buyback costs be deferred if there are undue delays due to consents for the construction of the reinforcement pipelines, adverse weather conditions or other exceptional factors?

As set out in our response to question one, we firmly believe that National Grid Gas NTS should only be incentivised on elements that are within our control.

Therefore, we believe that our exposure to buyback costs should indeed be deferred if there are undue delays in the ability to release capacity due to consents for the construction of the reinforcement pipelines, adverse weather conditions or other exceptional factors which are beyond our control.

If our exposure were not deferred in relation to elements outside of our control, we believe that this would lead to an increase in our overall business risk which would need to be taken into account in relation to our potential returns on the necessary investments associated with the Milford Haven capacity release.

Question 4

What are the advantages and disadvantages of the new incentive arrangements described in this chapter?

Given the strategic importance and scale of the Milford Haven project we can understand Ofgem's desire to strengthen the financial incentives. Furthermore, given that delivery is due at the beginning of the next price control period, we recognise the desire to establish a degree of certainty over the incentive regime that may apply in relation to Milford Haven.

As part of the main Transmission Price Control Review, we look forward to working with Ofgem to agree the overall risk and remuneration package that will apply to National Grid Gas NTS through both the proposed incentive schemes and the treatment of new investments to be agreed as part of the price control.

In relation to the proposed incentive scheme we can see advantages of the scheme provided that the arrangements are based closely on the principles identified in paragraph 4.3 of the consultation and, as stated above:

- They are based on activities that are substantially within National Grid Gas NTS' control (such as construction activities). Other factors outside our control (such as the timing of necessary consents being granted) should be excluded from the incentive scheme; and
- Any incentives are consistent with the overall returns being made on the Milford Haven investment.

We believe that there would be a clear disadvantage, however, if the arrangements did not take on board these two elements and provide an appropriate risk and reward balance.

From the options being consulted upon, we believe that Option D would appear to be the most appropriate option as it retains a continuing incentive to deliver over time. Options such as A have the disadvantage of the incentives capping out and thereby delivering no financial incentive on National Grid Gas NTS to deliver after that date,

There are potential disadvantages of setting a scheme in advance of the conclusion of the broader discussions taking place as part of the transmission price control although we do recognise the drivers leading to the timing of this consultation. Given these disadvantages we would therefore propose that any formal licence changes and subsequent changes to other documents should be undertaken in parallel with other changes to these documents which result from the transmission price control process and are not implemented in isolation ahead of those changes.

Question 5

Should this deferral "skip" the period November - February during which construction is not practical?

As previously mentioned in our answers to question 1 and 3 above, we are of the firm view that we should only be incentivised on elements that are within our control.

Therefore, we would agree with a deferral to allow financial exposure under the incentive scheme to "skip" the period November – February during which construction is not practical, if a failure to deliver the necessary investment by the end of October 2007 were as a result of factors that were outside of our control such as the late delivery of consents, adverse weather and force majure or exceptional type events. In the event that weather conditions were such that construction work could not commence until April (rather than March) then the "skip" period should take this into account.

Question 6

What are the advantages and disadvantages of the new incentive arrangements described in this chapter?

This is a duplication of question 4 therefore please refer to our answer to question 4 above.

Question 7

Are there further steps that should be taken to encourage National Grid Gas NTS and the relevant shippers to enter into arrangements that would minimise the economic costs of any delay in the provision of transmission capacity at Milford Haven?

We are happy to discuss with the relevant shippers the matter of capping the liabilities associated with buybacks in the event that these should ever arise. Our main actions however, will be to continue to focus on the timely delivery of the required the network investment in order to avoid any possible delay in the provision of the capacity at Milford Haven which would trigger costs to the industry.