

Incentive arrangements for the provision of NTS entry capacity at Milford Haven

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Overview:

This document sets out Ofgem's conclusion on the introduction of new incentive arrangements for National Grid Gas plc as gas transporter in respect on the National Transmission System ("National Grid Gas NTS") in relation to the provision of gas transmission capacity at the new system entry point at Milford Haven. National Grid Gas NTS has sold gas transmission capacity at this entry point which may now be delivered later than envisaged at the time of the auctions. The incentives:

- encourage National Grid Gas NTS to provide new capacity in a timely and efficient manner
- ensure that the costs of any delays are shared between consumers, shippers and National Grid Gas NTS in an appropriate way, and
- provide a baseline against which shippers and the developers of LNG supply chain can plan their activities.

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Target Audience: National Grid Gas NTS, gas shippers and suppliers, representatives of consumers and any other interested parties.

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Context

In the quarterly system entry capacity (QSEC) auctions in 2004 National Grid Gas NTS sold gas transmission capacity at Milford Haven from October 2007. However the reinforcement investment required for additional capacity may not be completed until 2008.

If National Grid Gas NTS is unable to provide capacity which it has sold on a firm basis then it is subject to buyback liabilities under the provisions of the Uniform Network Code (UNC). Given the potential for disruption to Liquefied Natural Gas (LNG) supply chains the costs of this disruption could be relatively large. The present incentive arrangements include a cap on National Grid Gas NTS's exposure to these liabilities to £12½ million in each formula year, with any remaining buyback liability being recovered across all shippers and consumers. It was originally envisaged that these incentives would be revised during the main transmission price control review and new incentives put in place from April 2007.

The process for planning and construction of the reinforcement work necessary to provide the capacity is already underway. The new regulatory arrangements should further increase the incentives on National Grid Gas NTS to deliver the transmission system reinforcement in a timely way.

Associated Documents

In April 2006 Ofgem published a consultation document on additional incentives in relation to Milford Haven¹.

¹ " Proposed Incentive Arrangements for the Provision of NTS Entry Capacity at Milford Haven", Ofgem 63/06, April 2006, http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/14568_6306.pdf?wtfrom=/ofgem/whats-new/archive.jsp

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Summary

Gas entry development at Milford Haven

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The process for planning and construction of the reinforcement work necessary to provide the capacity is already underway.

Options for consultation in April 2006

In April 2006 Ofgem published a consultation document on additional incentives in relation to Milford Haven². This document proposed increasing the incentive on National Grid Gas NTS in respect of capacity buybacks at Milford Haven to £36m and consulted on options for profiling this incentive and allowing deferrals of the implementation of the incentive in certain circumstances.

Ofgem's decision

Ofgem has decided the imposed a buyback incentive on National Grid Gas NTS with a total value of £36m. This will be profiled as illustrated in Table 1.

Table 1 - Profiling of incentive

2007			2008									
Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Total
£2m	£2m	£2m	£6m	£6m	£6m	£2m	£2m	£2m	£2m	£2m	£2m	£36m

² " Proposed Incentive Arrangements for the Provision of NTS Entry Capacity at Milford Haven", Ofgem 63/06, April 2006,
http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/14568_6306.pdf?wtfrom=/ofgem/whats-new/archive.jsp

The incentive on National Grid Gas NTS will be deferred (i.e. will start later than that indicated in Table 1) in the event of delays in delivery of capacity can be attributed to DTI taking longer than three months to provide environmental consents.

Ofgem will also consider deferring the incentives in relation to delays caused by *force majeure* events.

1. Background

1.1. The present price control and incentive arrangements were put in place following the 2001 Transco price control review. They were designed to provide incentives on what is now National Grid Gas NTS to invest in the gas National Transmission System (NTS) in a timely and efficient manner. The entry capacity auctions were intended to ration scarce capacity efficiently and to allow shippers to signal their long term needs for entry capacity.

Baselines for Entry Capacity at Existing Terminals

1.2. At the last price control review Ofgem based National Grid Gas NTS's transmission operator (TO) price control revenue on a range of entry and exit capacity output measures for each of the five years of the control period. The level of maximum physical capacity at each existing NTS entry point defined the TO baseline for entry capacity. Ofgem also defined a System Operator (SO) entry baseline calculated as ninety percent of the TO entry baseline.

1.3. National Grid Gas NTS's transmission operator (TO) price control revenue comes half from entry charges and half from exit charges. Entry charges are largely determined in long-term and short-term auctions.

1.4. National Grid Gas NTS is obliged to offer for sale the output measures defined within its licence through a series of long-term and short-term entry capacity auctions. Capacity is offered in quarterly blocks in long-term entry capacity allocations and in monthly and daily blocks in the shorter term auctions.

1.5. In addition to the requirements to make baseline obligated entry capacity available National Grid Gas NTS must also make available incremental entry capacity (typically up to 150 *percent* of the SO baseline) available in the Quarterly System Entry Capacity (QSEC) auctions. This allows shippers to signal the need for additional capacity. These arrangements are described in the following section.

QSEC Auctions and Incremental Capacity

1.6. The provision of capacity beyond the baselines typically requires National Grid Gas NTS to invest in new infrastructure and so the provision of this additional capacity is subject to a Net Present Value (NPV) test.

1.7. National Grid Gas NTS's Incremental Entry Capacity Release (IECR) Methodology Statement specifies that the NPV test requires the aggregate value of bids over eight years to equal at least half the assumed project value. The assumed project value is an estimate of the costs of providing incremental entry capacity and is calculated by multiplying the volume of incremental entry capacity being considered for release by the entry point's UCAG. If the NPV test is met then National Grid Gas NTS will seek approval to release permanent incremental obligated entry capacity. To date Ofgem has approved all such requests that have been made by National Grid Gas NTS. It is then for National Grid Gas NTS to provide the additional network capacity, probably by investing in network reinforcement.

1.8. Consistent with the obligations in its licence in January 2005 National Grid Gas NTS notified Ofgem of its intention to release 650 GWh/day of permanent obligated incremental entry capacity from October 2007 and 950 GWh/day from January 2009 at Milford Haven to the shippers that had purchased entry capacity in the Long Term System Entry Capacity (LTSEC) auctions from October 2007. Ofgem did not veto the release of this capacity.

Capacity Buyback Incentives

1.9. National Grid Gas NTS is obliged to offer 90 percent of the TO baseline capacity for sale in the entry capacity auctions (i.e. the SO baseline). The auction arrangements established in the uniform network code (UNC) allow shippers to acquire certain financial rights to flow gas through entry points onto the NTS. If National Grid Gas NTS cannot provide baseline or permanent obligated incremental capacity that it has sold in an auction it has to buyback such capacity (possibly after interrupting any interruptible entry capacity) either in the daily buyback market or in advance through its capacity management agreements. Typically any buyback of entry capacity would be on the basis of bids made by the shippers that have purchased the entry capacity. National Grid Gas NTS faces an incentive to minimise these costs through capacity buyback incentive arrangements.

1.10. The entry capacity buyback incentive is a sliding scale incentive, with a target level of costs, sharing factors and a cap and collar. Table 2 summarises the key parameters of the buy-back incentive arrangements.

Table 2- Buyback Incentive

Targets, Cap and Collar (£m)					Sharing Factors	
Target 2002/3	Target 2003/4	Target 2004/5 - 2006/7	Cap	Collar	Upside	Downside
35	10-20	18	30	-12.5	50%	35%

1.11. Under the buyback incentive costs are defined as the costs National Grid Gas NTS incurs in buying back entry capacity less the revenue it earns from some types of entry capacity products (on-the-day sales of firm and interruptible NTS entry capacity, sales of non-obligated incremental firm NTS entry capacity) and also revenue from overrun charges (overrun charges are charges levied on a shipper when its total gas flowed at a terminal on a given gas day exceeds its holdings of entry capacity at that terminal on that day).

1.12. The purpose of buyback incentives is to allow National Grid Gas NTS to make efficient trade-offs in deciding to withhold capacity for operational reasons (e.g. maintenance) and to provide incentives to encourage the provision of new capacity in a timely manner. Therefore, National Grid Gas NTS could choose not to undertake investment associated with the obligated capacity release but in so doing it would potentially be exposed to entry capacity buy-back costs if it sells capacity that it cannot subsequently physically deliver. Owing to the caps and sharing factors in the incentive scheme National Grid Gas NTS would need to be able to demonstrate that these judgements had been made on a reasonable and efficient basis and were in the interests of consumers.

NTS neutrality charge

1.13. If National Grid Gas NTS were to incur very large buy back costs then, because of the cap on its liabilities, the extra costs would be recovered by the neutrality charge, which is spread across all shippers.

The April consultation

1.14. In April 2006 Ofgem published a consultation document on additional incentives in relation to Milford Haven³. This document proposed increasing the incentive on National Grid Gas NTS in respect of capacity buybacks at Milford Haven to £36m and consulted on options for profiling this incentive and allowing deferrals of the implementation of the incentive in certain circumstances. This incentive at Milford Haven was to be separate from any buyback incentive in relation to all other entry point introduced as part of the ongoing transmission price control review process.

1.15. This consultation is briefly considered in this chapter.

Profiling of incentives

1.16. Ofgem proposed four alternative options for the revised incentive scheme. Option A was to expose National Grid Gas NTS to £12 million of any buyback costs arising before 1 January 2008 and expose it to buyback costs after this date with a cap on its liabilities of £24 million. Option B involved caps of £4 million for each of the 3 months October 2007 to Dec 2007 and then £8 million per month January 2008 to March 2008, giving a total liability of no more than £36 million. Option C involved caps of £2m for each of the 3 months October 2007 to Dec 2007 and then £8 million per month January 2008 to March 2008 and £1m per month from April 2008 to September 2008. Option D involved caps of £2m for each of the 3 months October 2007 to Dec 2007 and then £6 million per month January 2008 to March 2008 and £2m per month from April 2008 to September 2008. These options are summarised in Table 3.

1.17. Under all the proposed approaches the same sharing factor (35 *percent*) would be applied to costs as now and the target level of costs would be zero - reflecting the desirability of National Grid Gas NTS delivering capacity consistent with the original timetable. Any buyback costs beyond National Grid Gas NTS's exposure would be spread across all shippers and so consumers.

³ " Proposed Incentive Arrangements for the Provision of NTS Entry Capacity at Milford Haven", Ofgem 63/06, April 2006, http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/14568_6306.pdf?wtfrom=/ofgem/whats-new/archive.jsp

Table 3 - Profiling options from the April document

	2007				2008									Total
	£m	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	
O P T I O N	A	12			24			0						36
	B	4	4	4	8	8	8	0						36
	C	2	2	2	8	8	8	1	1	1	1	1	1	36
	D	2	2	2	6	6	6	2	2	2	2	2	2	36

Other elements of the proposal

1.18. Ofgem also consulted on whether the commencement of National Grid Gas NTS's incentive should be deferred following delays due:

- Problems gaining consents (including environmental consents, planning permission, wayleaves and access to land).
- Adverse weather conditions
- *Force majeure* events

1.19. A related question was whether the incentive should jump over the winter period on the grounds that National Grid Gas NTS would be unable to work over the winter period due to weather conditions and land access restrictions

2. Ofgem's decision

2.1. Ofgem has decided to introduce an additional incentive in relation to the buyback of capacity at Milford Haven. This incentive at Milford Haven will be separate from any buyback incentive in relation to all other entry point being developed as part of the ongoing transmission price control review process.

Profiling of incentives

2.2. Ofgem has decided to implement Option D from Table 3.

2.3. This decision was reached as it maintains some incentive on National Grid Gas NTS for a longer time period than Options A or B and so continues to be useful even if delays are very severe. Option D also has the advantage of loading more of the incentive into the later period and so maintaining a stronger incentive in that period.

Deferrals of incentives

Weather deferral

2.4. Ofgem takes the view that managing the weather risks of a project is part of the business of any gas transportation company and therefore that it is not appropriate to defer the start of incentives for delays owing to adverse weather conditions.

Consents deferral

2.5. Ofgem takes the view that getting access to land wayleaves and planning permission are part of the business of a gas transportation company. Ofgem does not therefore propose deferring the start of incentives for delays owing to difficulties gaining these consents.

2.6. However Ofgem considers that the timeframe required from DTI in granting environmental consents (3 months) for this project is unusually tight. Hence Ofgem is content that it is not appropriate for National Grid Gas NTS to bear the risk associated with delays beyond this timeframe. Therefore the start of the incentives will be deferred for delays arising from the DTI taking longer than 3 months to provide environmental consents.

2.7. It is therefore the case that consumers will bear the costs of any delay beyond 3 months in the DTI granting these consents.

Force majeure deferral

2.8. Ofgem has considered whether it is appropriate to allow an automatic deferral of the incentives for *force majeure* events. On consideration Ofgem considers that an automatic deferral is inappropriate. However Ofgem does consider that, in the event of large scale unanticipated events causing delays to the project, National Grid Gas NTS should be able to approach Ofgem to seek a change to the incentive regime to take account of these events.

2.9. In granting any such change Ofgem would need to be convinced that the event was genuinely unpredictable and that National Grid Gas NTS has used best endeavours to mitigate the problems arising therefrom.

Winter period working

2.10. Ofgem is not proposing that the incentives should be automatically deferred over the whole of the winter period (e.g. whether a one month delay in getting approvals should lead to a five month delay in the commencement of the incentives) as to do so would remove any incentive from National Grid Gas NTS to find innovative ways to arrange its work and achieve some development of the project over that period.

2.11. However, where there is a deferral of the incentive for one of the reasons discussed above, Ofgem will consider any representations made by National Grid Gas NTS that it would be appropriate to make the deferral more than one day for each day's delay to take account of problems with working during the winter period.

3. Next steps

Licence modifications

3.1. Ofgem intends to bring in the licence modifications necessary to implement this policy along side other licence modifications relating to the TPCR project which will take effect from 1 April 2007. This will ensure that the incentives are in place in advance of 1 October 2007 when they will start to have effect.

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Appendix 1 - Consultation questions

1.1. In its consultation document " Proposed Incentive Arrangements for the Provision of NTS Entry Capacity at Milford Haven" 63/06Ofgem sought the views of respondents about a number of questions as set out below:

CHAPTER: Four

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?

Question 2: are the principles identified in paragraph 4.3 an appropriate basis for new incentive arrangements?

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?

Question 4: this question was included in the document by error and so is omitted here

Question 5: Should this deferral 'skip' the period November February during which construction is not practical?

Question 6: What are the advantages and disadvantages of the new incentive arrangements described in this chapter?

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?

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List of Respondents

List	Name
1	Association of Energy Producers
2	BG Group
3	BP UK Gas & Power
4	Chemical Industries Association
5	EDF Energy
6	Energywatch
7	ExxonMobil International Limited
8	National Grid plc
9	PETGAS Trading (UK) Limited
10	RWE npower
11	Scottish and Southern Energy
12	Shell Gas Direct Limited
13	Statoil (U.K.) Limited
14	Total E&P UK Limited
15	Total Gas & Power Limited

Summary of Responses

1.2. Responses received by Ofgem which were not marked as being confidential have been published on Ofgem's website www.ofgem.gov.uk. Copies of non-confidential responses are also available from Ofgem's library (library@ofgem.gov.uk) .

1.3. The following is a summary of those responses which were received.

1.4. National Grid reiterated its commitment to delivering the network infrastructure required for Milford Haven in a timely and efficient fashion but recognised Ofgem's intention to strengthen the financial incentives.

1.5. Respondents other than National Grid generally considered it appropriate, in the context of the current price control regime, that National Grid should be subject to additional incentives in relation to the delivery of capacity at Milford Haven.

1.6. National Grid favoured profiling option D as that provides a continuing incentive to deliver over time.

1.7. National Grid felt that it should only be incentivised for matters within their control and therefore felt that it should be entitled to the carve outs for all the factors identified in the document and that the incentives should jump the winter period (November - February) when it considered that construction is not practical.

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1.8. The views of respondents on the appropriate profiling of incentives varied with support expressed for options A, C and D. The respondents with a direct interest in the Milford Haven development expressed a preference for option B..

1.9. Other respondents generally felt that National Grid should not receive any of these carve outs as they contended that managing such risk was a core part of National Grid's functions as a network company. Respondents also felt that National Grid had had sufficient time to anticipate many of the issues for which Ofgem consulted on deferrals and therefore that it was inappropriate to protect National Grid from such exposure.

1.10. To the extent respondents were content that there be deferrals of the incentives they wished for assurance that the delays were not due to factors that were within National Grid's control.

1.11. Some respondents also expressed concerns that the buyback regime was not appropriate (or was not sufficient in itself) to incentivise appropriate delivery of capacity.

Appendix 2 - Feedback questionnaire

1.1. Ofgem considers that consultation is at the heart of good policy development. We are keen to consider any comments or complaints about the manner in which this consultation has been conducted. In any case we would be keen to get your answers to the following questions:

- Does the report adequately reflect your views? If not, why not?
- Does the report offer a clear explanation as to why not all the views offered had been taken forward?
- Did the report offer a clear explanation and justification for the decision? If not, how could this information have been better presented?
- Do you have any comments about the overall tone and content of the report?
- Was the report easy to read and understand, could it have been better written?
- Please add any further comments?

Please send your comments to:

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Appendix 3 - The Authority's Powers and Duties

1.1. Ofgem is the Office of Gas and Electricity Markets which supports the Gas and Electricity Markets Authority ("the Authority"), the regulator of the gas and electricity industries in Great Britain. This Appendix summarises the primary powers and duties of the Authority. It is not comprehensive and is not a substitute to reference to the relevant legal instruments (including, but not limited to, those referred to below).

1.2. The Authority's powers and duties are largely provided for in statute, principally the Gas Act 1986, the Electricity Act 1989, the Utilities Act 2000, the Competition Act 1998, the Enterprise Act 2002 and the Energy Act 2004, as well as arising from directly effective European Community legislation. References to the Gas Act and the Electricity Act in this Appendix are to Part 1 of each of those Acts.⁴

1.3. Duties and functions relating to gas are set out in the Gas Act and those relating to electricity are set out in the Electricity Act. This Appendix must be read accordingly⁵.

1.4. The Authority's principal objective when carrying out certain of its functions under each of the Gas Act and the Electricity Act is to protect the interests of consumers, present and future, wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities connected with, the shipping, transportation or supply of gas conveyed through pipes, and the generation, transmission, distribution or supply of electricity or the provision or use of electricity interconnectors.

1.5. The Authority must when carrying out those functions have regard to:

- The need to secure that, so far as it is economical to meet them, all reasonable demands in Great Britain for gas conveyed through pipes are met;
- The need to secure that all reasonable demands for electricity are met;
- The need to secure that licence holders are able to finance the activities which are the subject of obligations on them⁶; and
- The interests of individuals who are disabled or chronically sick, of pensionable age, with low incomes, or residing in rural areas.⁷

1.6. Subject to the above, the Authority is required to carry out the functions referred to in the manner which it considers is best calculated to:

- Promote efficiency and economy on the part of those licensed⁸ under the relevant Act and the efficient use of gas conveyed through pipes and electricity conveyed by distribution systems or transmission systems;

⁴ entitled "Gas Supply" and "Electricity Supply" respectively.

⁵ However, in exercising a function under the Electricity Act the Authority may have regard to the interests of consumers in relation to gas conveyed through pipes and vice versa in the case of it exercising a function under the Gas Act.

⁶ under the Gas Act and the Utilities Act, in the case of Gas Act functions, or the Electricity Act, the Utilities Act and certain parts of the Energy Act in the case of Electricity Act functions.

⁷ The Authority may have regard to other descriptions of consumers.

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- Protect the public from dangers arising from the conveyance of gas through pipes or the use of gas conveyed through pipes and from the generation, transmission, distribution or supply of electricity;
- Contribute to the achievement of sustainable development; and
- Secure a diverse and viable long-term energy supply.

1.7. In carrying out the functions referred to, the Authority must also have regard, to:

-
- The effect on the environment of activities connected with the conveyance of gas through pipes or with the generation, transmission, distribution or supply of electricity;
- The principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed and any other principles that appear to it to represent the best regulatory practice; and
- Certain statutory guidance on social and environmental matters issued by the Secretary of State.

1.8. The Authority has powers under the Competition Act to investigate suspected anti-competitive activity and take action for breaches of the prohibitions in the legislation in respect of the gas and electricity sectors in Great Britain and is a designated National Competition Authority under the EC Modernisation Regulation⁹ and therefore part of the European Competition Network. The Authority also has concurrent powers with the Office of Fair Trading in respect of market investigation references to the Competition Commission.

⁸ or persons authorised by exemptions to carry on any activity.

⁹ Council Regulation (EC) 1/2003

Appendix 4 - Glossary

D

DTI

Department of Trade and Industry

G

GWh/day

Gigawatt hours per day

I

IECR

Incremental Entry Capacity Release

L

LNG

Liquefied Natural Gas.

LTSEC

Long Term System Entry Capacity

M

MSEC

Monthly System Entry Capacity

N

National Grid Gas NTS

National Grid operating in its capacity as operator of the NTS.

NPV

Net Present Value. For discount rate δ the NPV of an income stream

$X = \{x_0, x_1, \dots, x_T\}$ is given by
$$NPV(X) = \sum_{t=0}^T \delta \cdot x_t$$

NTS

National Transmission System

O

Ofgem

The Office of Gas and Electricity Markets.

Q

QSEC

Quarterly System Entry Capacity

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S

SO

System Operator

T

TO

Transmission Operator

U

UCAG

Gross Unit Cost Allowance

UNC

Uniform Network Code