Sonia Brown
Director, Wholesale Markets
Office of Gas and Electricity Markets
9 Millbank
London
SW1P 3GE

Chris Bennett
Transmission Regulation Manager
chris.bennett@uk.ngrid.com
Direct tel +44 (0)1926655949

www.nationalgrid.com

04 August 2006

National Grid Gas System Operator Incentives 2007-2008
Invitation to Submit Views

Dear Sonia

Executive Summary

We welcome the opportunity to comment on Ofgem's invitation to submit views on National Grid Gas Transmission's System Operator (SO) incentives. 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")

Within this executive summary, the overall structure of the response concentrates on the principles associated with incentives, the generic cost drivers, the uncertainties facing the NTS in the future and the main points from our detailed response. We have also provided:

- Appendix A - National Grid Gas NTS's answers to the more detailed questions contained in the invitation to submit views.
- Appendix B – An overview of performance against each of the SO incentives for formula years 2002/03 to 2005/06, including the key initiatives and events which have contributed to the performance.

<u>The purpose of incentives</u>

As a matter of principle we continue to believe in and support the use of appropriate financial incentives. We believe that a number of principles should apply in relation to incentive arrangements and these are set out below:

- Financial incentives should provide an appropriate balance of risk and reward that aligns the interest of the transmission company with those of consumers and be consistent with our economic and efficient licence obligation;
- We believe that incentives should be focused on elements that are within our control and not be distorted by elements over which we have no direct control;
- Incentives should protect National Grid Gas NTS from risks that might have the effect of materially increasing its overall business risk and cost of capital beyond that assumed in setting the price control;
- Incentives should ensure the targeting of costs at those who have caused the costs;
- Incentives should be consistent with a stable regulatory, operational and commercial frameworks.

We believe that the principles above form a good basis for any incentive arrangements and we would welcome further discussion with Ofgem in relation to this area.

Key drivers of external costs

Over the forthcoming price control we believe that there will be a number of drivers that will impact external costs. These are detailed below:

Changing supply sources

During the present price control period, gas flows have typically been from the North to the South. Moving into the next price control period, greater flow complexity and variability will exist with an expectation that flows could change so that gas flows from West to East, East to West and North to South triggered by access to more diverse sources of supply. With this diversity comes uncertainty, for example, as the UK supply market will increasingly become influenced by the world gas market, as supplies imported through LNG facilities or through interconnectors have a number of alternative markets into which they could be sold.

In relation to changing supply sources we believe that the following SO incentives will be heavily impacted:

- Entry Capacity investment;
- Exit capacity investment;
- Entry capacity buyback;
- System balancing – shrinkage; and
- System balancing – system reserve.

TO Investment

When considering the SO incentives it is important to note that a number of the incentives are impacted by the actual level of investments made within the network. National Grid Gas NTS notes from Ofgem's Initial Proposals document that considerable uncertainty exists as to which investments will ultimately be allowed within the TO RAV, and hence until this uncertainty is removed we cannot provide definitive estimates of future costs or agree targets for the above schemes.

Commercial Regime

In relation to the commercial regime, considerable uncertainty still remains in relation to the impact of exit reform (particularly flow flex). As such, given the uncertainty surrounding the commercial regime, we believe that this should be taken into account when setting the targets for the shallow incentives (as per entry).

The future funding of LNG

As part of the Transmission Price Control Review, we are aware that discussions are taking place in relation to the future funding of LNG. We believe that there are some fundamental issues surrounding the topic of LNG which need careful consideration as part of the price control process. Indeed, the future funding of LNG will be of particular relevance to the System balancing – system reserve incentive.

Whilst we have provided detailed answers to the questions raised by Ofgem in Appendix A, we have highlighted below our main points in relation to the System Operator Incentives:

Performance of the incentives

During the period of the last price control up to the end of formula year 2005/06, consumers have directly benefited to the value of over £110 million through the operation of the incentive schemes. In relation to the system operator incentives we have consistently managed the cost of the incentives to the positive benefit of end consumers. This out-performance during the period of the last price control can be attributed to a number of initiatives including:

- Reviews of operational practices;
- The continued use of operational incentives and strategies;
- Significant release of non-obligated capacity.
- The use of forward and options contracts;
- An extensive risk management programme;
- The development and implementation of technical training programmes;
- Strong trading performance; and
- Meter assurance programmes

Within Appendix B, we have highlighted performance for formula years 2002/03 to 2005/06, in addition to discussing the reasons for the performance in relation to each of the incentives.

Form and scope of the incentives

We continue to believe that for each of the SO incentive schemes that are comprised within the overall incentive regime, it would be appropriate to include targets, sharing factors and a cap and a collar.

Duration of the incentives

In terms of the duration of any incentive scheme, in theory we believe that incentive schemes longer than one year in duration are of greater benefit to the community. However, we appreciate that it is Ofgem's wish to set the incentives for just the one year period to only cover 2007/08. For the period post 2007/08, we believe it would be beneficial and more efficient to consider schemes that are longer than one year in duration and we look forward to discussing this area during the next review of the shallow incentives.

Conclusion

I look forward to working with you on developing the NTS System operator incentives for 2007/08.

Yours sincerely,

By email

Chris Bennett

Transmission Regulation Manager