

Question B.1: Are the form and scope of the incentive schemes still appropriate?**Form and scope**

As a matter of principle, we continue to believe in and support the use of appropriate financial incentives and we believe that a number of principles should apply in relation to incentive arrangements, 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 framework

We believe that incentives present a number of positive attributes for both consumers and National Grid Gas Transmission and we consider that the principles highlighted above are sound and should continue to form the basis for the development or basis of incentive schemes.

In relation to the present system operator incentives, we have consistently managed the costs of the incentives to the positive benefit of end consumers. For example, during the period of the last price control up to the end of formula year 2005/06, consumers have benefited to the value £112.6 million through the application of the incentive schemes. We have included within Appendix B our performance for each of the formula years 2002/03 to 2005/06 together with details of the initiations which have led to out performance.

When considering the form and scope of the incentive schemes, we believe that it would be appropriate to continue to include targets, sharing factors and a cap and collar. By including such components a risk/reward profile is designed that presents favourable attributes to both the transmission company and consumers.

We support the use of a sliding scale approach, as a mechanism for aligning the interests of National Grid Gas Transmission and consumers, and the continuation of the separation of the incentive scheme into discrete components. The use of sharing factors and caps and collars also ensures the targeting of costs to the appropriate parties. However, over the forthcoming months we believe that further consideration should be given to areas such as price indexation of targets to reflect the potential significant uncertainty of prices and their impact on the incentives schemes.

Duration

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 could be beneficial 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.

Risk exposure

In relation to the shallow incentive schemes, we are of the view that incentives should protect National Grid Gas NTS from risks that might have the effect of unduly increasing its overall business risk and cost of capital beyond that assumed in setting the price control.

Question B.2: Should future incentives continue to last for two years or should they be shorter or longer?

Please refer to our views outlined in response to question B.1

Question B.3: Are daily incentive payments, subject to annual cap and floor, still appropriate?

Please refer to our response to question B.4

Question B.4: Are both residual balancing incentive schemes still required?

Role of National Grid Gas NTS

National Grid has a licence obligation as residual balancer to “undertake engagements relating to the acquisition or disposal of gas to ensure the safe and efficient operation of the transportation system.”

Purpose of the residual balancing incentive

When considering the residual balancing incentive, it should be remembered that this was introduced to provide incentives on Transco (as National Grid was known at the time).

- ◆ to transact gas for balancing purposes at prices close to the prevailing market price; and
- ◆ to optimise day on day closing NTS linepack positions.

Taken together these two components were designed to optimise the trade-offs and deliver a low-cost balancing service and ensure that such costs/credits are targeted closely to the days in which such costs/credits arise and therefore to the relevant shippers.

In relation to the residual balancing incentive, we believe that the principles highlighted above are still relevant to the operation of the incentive and therefore, we continue to support the retention of the current form of the residual gas balancing incentive, namely to retain the two parts

- ◆ Daily linepack element; and
- ◆ Daily price element.

However, we believe that the parameters of the scheme may need to be reviewed in the forthcoming months, in order to fully reflect the importance of the role.

Areas requiring further consideration

However, over the forthcoming price control period, we believe there are a number of factors that are worthy of consideration which may impact on the residual balancing incentive. We have highlighted these below:

The reform of offtake arrangements

We believe that it should be noted that there is an interaction between the operation of the linepack element of the incentive and the ultimate reform of offtake arrangements. Therefore, any changes to offtake would need to be taken into account in relation to the parameters of the scheme.

Gas system reserve review

We are also aware that Ofgem is considering whether any changes are required in relation to the level of gas system reserve ahead of winter 2007/08. We look forward to working with Ofgem and the community in relation to this area.

Appendix A

However, we are of the firm view that if there were changes to the level of gas system reserve or indeed to National Grid Gas NTS's role as residual balancer; these changes would need to be taken into account in relation to the parameters within the shallow incentives.

We believe that any review of incentive schemes should not expose us to further risks than those that we already face.

Question B.5: Are both system balancing incentive schemes still required?

Under Special Condition C8A: Revenue restriction definition in respect of the NTS transportation activity and NTS system operation activity, National Grid Gas NTS undertakes a number of activities in its role as system operator. Given that this obligation is ongoing, it is appropriate for both system balancing incentives to remain in place.

In relation to the system balancing incentives for the period of the next price control, it is important to note that considerable uncertainty exists in relation to a number of areas including:

- ◆ Changing supply sources;
- ◆ TO Investment;
- ◆ The future funding of LNG; and
- ◆ Commercial Regime.

As such, consideration should be given to these factors, when taking into account the parameters of these incentives.

Question B.6: Is NGG's 100% exposure under these incentives still appropriate?

System Balancing – System Reserve (OM)

In March 2006, National Grid Gas NTS published a "Request for Proposals" (RFP) in relation to Operating Margins. Within the RFP, National Grid Gas NTS made clear to the market our intention to purchase services from independent third party providers over the course of the next price control period.

In addition, we believe that the target cost for OM needs to reflect the proper market rate. Over recent months, we have seen large increases in cost at Rough Hornsea and in the market price of LNG.

Therefore, we are view that our exposure going forwards under this incentive should not be 100% as we are taking appropriate steps to ensure contestability and transparency in the market. Therefore, we would welcome early discussion with Ofgem in relation to the introduction of a more appropriate target, sharing factors and a cap and collar for this incentive.

System Balancing – Gas Cost Shrinkage

For clarification, it should be noted that the Gas Cost Shrinkage incentive covers more elements than indicated within Ofgem's letter (as outlined within Appendix B) and that National Grid Gas NTS does not face a 100% exposure under this incentive. At the present time, the upside sharing factor for the incentive is 25% and the downside sharing factor is 20%. We continue to believe that it is appropriate for performance under this incentive to be shared between National Grid Gas NTS and customers.