

## Transmission price control review: Draft licence conditions (gas) second informal consultation

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**Target audience:** This document will be of interest to network owners and operators, generators, shippers, suppliers, customers and other interested parties.

### Overview:

In December 2006 we published our final proposals following our review of the price controls of the four transmission companies in electricity and gas. Our proposals have now been accepted in principle by the companies and will take effect from 1 April 2007. To give effect to our proposals we need to amend the licences of each of the four companies, including the licence of National Grid Gas. Throughout the process we have engaged the licensees to develop licence drafting that accurately reflects our final proposals, and serves to enhance the clarity and robustness of the existing licence provisions.

We expect to continue to utilise bilateral discussions from now until the publication of our formal notices to further develop the licence drafting. Please note that the drafting will be subject to further review following our bilateral meetings with the licensees, and is therefore subject to change.

This document is our second informal consultation on the detailed changes that we propose to make to the licences of the National Grid Gas NTS (NGG NTS). There are a few amendments that require further work and will be subject to a further consultation in due course.

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## Context

Over the past two years we have been in the process of reviewing the price controls of the four transmission companies we regulate. The price controls determine how much revenue each of the companies is permitted to recover, generally over a five year period. This is an important process to ensure we continue to regulate network monopolies effectively by implementing provisions so that the companies can finance their activities and by providing the companies with the right set of financial incentives to act in the interests of consumers.

This process has now concluded with the publication of our final proposals in December 2006. In order to give effect to our proposals, however, we must modify the transmission licences held by each of the companies. The licences are the means by which the companies are bound to the terms of our new price controls. It is important therefore that the licences reflect our policy as set out in the final proposals document in an accurate and unambiguous manner. The process of consultation on the draft licence conditions is designed to ensure that these aims are met.

## Associated Documents

- TPCR 2007-2012 Draft licence conditions - NGET Transmission Licence Special Conditions - second informal consultation - Appendix 6, January 2007 (Ref No. 10a/07)
- TPCR 2007-2012 Draft licence conditions (electricity) - second informal consultation - Appendix 7, January 2007 (Ref No. 10b/07)
- TPCR 2007-2012 Draft licence conditions (electricity) - second informal consultation - Appendix 8, January 2007 (Ref No. 10c/07)
- TPCR 2007-2012 Draft licence conditions (electricity) - second informal consultation - Appendix 9, January 2007 (Ref No. 10d/07)
- National Grid Electricity Transmission and National Grid Gas System Operator Incentives from 1 April 2007, Initial Proposals, December 2006 (Ref No. 208/06)
- TPCR 2007-2012 Final Proposals, Decision Document, December 2006 (Ref No. 206/06)
- TPCR 2007-2012 Final Proposals - Appendices, December 2006 (Ref No. 206/06b)
- TPCR 2007-2012 Draft Licence Modifications, November 2006 (Ref No. 197/06)
- TPCR 2007-2012 Draft Licence Modifications - Appendices, November 2006 (Ref No. 197/06a)
- TPCR 2007-2012 Updated Proposals, September 2006 (Ref No. 170/06)
- TPCR 2007-2012 Updated Proposals - Appendices, September 2006 (Ref No. 170/06a)
- TPCR 2007-2012 Initial Proposals, June 2006 (Ref No. 104/06)
- TPCR 2007-2012 Initial Proposals, Main Appendices, June 2006 (Ref No. 104b/06)
- Access Reform in Electricity Transmission: Working group report and next steps, May 2006 (Ref No. 83/06a)

- A framework for considering reforms to how generators gain access to the GB electricity transmission system: A report by the Access Reform Options Development Group April 2006, May 2006 (Ref No. 83/06b)
- TPCR 2007-2012: Third Consultation, March 2006 (Ref No. 51/06)
- TPCR 2007-2012: Third Consultation, Supplementary Appendices, March 2006 (Ref No. 51/06b)
- TPCR Capital Expenditure Projections 2007-2012 (open letter), 1 February 2006 (Ref No. 21/06)
- TPCR Second Consultation, December 2005 (Ref No. 277/05)
- TPCR Initial Consultation, July 2005 (Ref No. 172/05)

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## Summary

This document sets out the changes we are proposing to the licences of the National Grid Gas NTS (NGG NTS) to give effect to the transmission price control review final proposals. It is necessary to amend some existing conditions, delete others and introduce new conditions. In addition, we will also take the opportunity to rationalise the licences, including making various housekeeping changes and amendments to enhance the clarity of the provisions of the licensees' obligations.

We published our final proposals for the transmission price control review in December 2006. NGG NTS has now announced their acceptance, in principle, of our proposals.

The licences are legal documents and, among other things, the vehicle through which the companies are bound to the terms of our proposed new price controls. It is important that the detail of our proposals is implemented clearly, accurately and unambiguously. To meet this objective we have chosen to consult on the changes we are proposing before we formally propose their implementation. This document is the second informal consultation and will be followed by the publication of draft section 23 notices in February, which will be followed by the formal statutory consultation pursuant to sections 23 and 23A of the Gas Act 1986 in March/April 2007.

This document sets out the proposed changes to NGG NTS's licence. The main document summarises the changes, highlights any particular points to note and provides references to the relevant appendices where the draft legal text is set out. It also sets out our proposed amendments and additions to the standard licence conditions. There are four chapters in the main document explaining our proposed licence changes in respect of:

- Price control and general framework
- Gas Offtake
- Regulatory Reporting

Please note that the drafting providing the appendices to this document will be subject to further review following our bilateral meetings with the licensees, and is therefore subject to change.

## 1. Price control framework

### Chapter Summary

This chapter describes the changes we are proposing to make to the licence of NGG NTS in respect of the core price control formula and associated matters. It also describes the process we are adopting to align these changes with the process of implementing analogous changes to the NGET's System Operator (SO) revenue restriction.

### Questions

**Question 1.1:** Do you have any comments on the proposed licence drafting?

### Introduction

1.1. At present, Special Condition C8B of the NTS licence contains all of the key price control provisions for both the NTS transportation owner (TO) and NTS system operation (SO) activities including the incentives placed upon NGG NTS with respect to its SO activities at gas entry and gas exit and with respect to gas balancing and internal costs.

1.2. We are proposing to replace C8B with a number of new separate conditions that will cover different aspects of the TO and SO regime. We have not included drafting relating to the entry regime within this consultation as there still remains a significant amount of work in what is complex area of the regime. We intend to publish this drafting as part of our further consultation which will comprise a draft notices pursuant to section 23 and 23A.

1.3. We consider that our proposed restructuring of the existing condition will make the licence more transparent, provide greater clarity and easier to enforce.

1.4. We propose to replace the existing Special Condition C8B with the following conditions:

- Special Condition C8B (The NTS transportation owner activity revenue restriction), which sets out the headline TO price control;
- Special Condition C8C (The NTS system operation activity revenue restriction), which sets out the high-level provisions in respect of the SO price control;
- Special Condition C8D (NTS gas entry incentives, costs and revenues), which includes the licence provisions relating to gas entry to inform the derivation of TO and SO revenues in Special Conditions C8B and C8C respectively;
- Special Condition C8E (NTS gas exit incentives, costs and revenues), which includes the licence provisions relating to gas exit to inform the derivation of TO and SO revenues in Special Conditions C8B and C8C respectively;

- Special Condition C8F (Other NTS System Operator external incentives, costs and revenues), which includes the licence provisions relating to SO activities such as system balancing, residual gas balancing and the quality of information to inform the derivation of SO revenues in Special Condition C8C; and
- Special Condition C8G (NTS System Operator internal incentives, costs and revenues), which includes the licence provisions relating to the management of SO internal costs to inform the derivation of SO revenues in Special Condition C8C.

1.5. For the purposes of this consultation, we have included the current drafting for Special Conditions C8B and C8E. Drafts of Special Conditions C8C and C8D will be form part of the next informal consultation in late February. This will include a complete set of draft changes and draft notices under section 23 and 23A of the Gas Act.

1.6. A separate modification process has been established to introduce the modifications of the NTS System Operator external and internal incentives. We will undertake a formal statutory consultation in late February on the changes to the existing Special Condition C8B to give effect to the final proposals in respect of the external and internal incentives. The introduction of new Special Conditions C8F and C8G will therefore represent only consequential amendments that arise due to the intention to restructure the existing C8B and will not make changes to the substance of the proposed SO schemes.

## Baseline revenue and main formula

1.7. The revenue restriction formula for transmission owner function of NGG NTS will be contained in the new Special Condition C8B. The purpose and structure of this proposed condition is discussed below.

### Special Condition C8A

1.8. The purpose of C8A is to provide a set of definitions for the terms used for the purposes of both the transmission owner and system operator revenue restrictions, which we intend will subsequently be reflected in the new special conditions C8B to C8G.

### Special Condition C8B

1.9. Special condition C8B is the revenue restriction for NGG NTS in respect of its TO activities. It sets out the following:

- The definition of TO revenue,
- The formula for setting the maximum amount of TO revenue in any given year,
- Obligations on NGG NTS to seek to ensure that it does not recover more than the maximum amount of TO revenue in any given year;
- Routine reporting obligations;

- The provisions enabling NGG NTS to seek dis-application of the TO revenue restriction.

1.10. TO revenue is defined, in broad terms, as revenue from the sale of baseline entry capacity, baseline exit capacity and revenue from other chargeable TO activities. It excludes revenue from the sale of baseline entry capacity on the gas day.

1.11. The formula for setting the maximum amount of TO revenue in any given year has four component parts:

- A base revenue allowance that increases in line with inflation each year,
- Pass through items,
- incentive revenue adjustments, including provisions for innovation funding and the capital expenditure incentive, and
- An adjustment for under or over recovery of TO revenue in the previous year.

1.12. Other than changes to amend cross-references, revise the dates consistent with the next price control period and the proposed revenue allowances from the Final Proposals in December 2006, the main changes proposed relative to the current TO provisions include the following:

- removal of the detailed derivation of gas exit revenues (as represented by the term TOExR) such that this is provided in the new gas exit condition Special Condition C8E;
- deletion of sub-paragraph (b) in the derivation of prescribed rates given that this provision relates to the allocation of prescribed rates costs prior to the sale, by Transco plc, of four of its GDNs, which occurred on 1 June 2005; and
- deletion of the customer safety net provisions which were inserted into the NTS licence to provide protection to gas customers in the event that National Grid Transco (NGT) only sold one of its GDNs (or sold a number of its GDNs to a single purchaser). Such provisions are no longer required given that NGT sold four of its GDNs to three purchasers on 1 June 2005.

1.13. We note that these provisions are currently held within Part 1a of the current draft of Special Condition C8B. We propose that the structure of these TO provisions in the new Special Condition C8B should remain largely unchanged relative to the current drafting of Part 1a.

### **Component parts of the main formulae**

1.14. As noted above, we propose to structure the revenue restriction in two parts setting out the formulae for the TO and SO activities in separate conditions. These will be supplemented by detailed calculations feeding into particular terms in main formulas.

**Special Condition C8E**

1.15. This condition sets out the detail of the SO costs and revenues relating to the provision of gas offtake capacity, and the associated capacity release obligations. It is discussed in chapter 3 below.

**Release of incremental capacity**

1.16. Special Condition C8E sets out how the maximum SO revenue is affected by the release of offtake capacity, respectively, over and above the baseline levels. NGG NTS's licence also needs to provide a framework for establishing whether incremental capacity is made available to network users or not.

**Special Condition C18**

1.17. This condition sets out the framework for releasing incremental offtake capacity.

**Attribution of costs and revenues**

1.18. The revenue restriction we are proposing for NGG NTS requires the attribution of costs and revenues to particular activities and incentive schemes.

**Special Condition C9**

1.19. This condition sets out the principles which NGG NTS must apply in allocating costs and revenues to the TO and SO revenue restrictions and the underpinning individual incentive schemes.

**Special Condition C10**

1.20. This condition defines the chargeable activities (and therefore the revenues) that fall outside the scope of the TO or SO revenue restriction. These are termed Excluded Services.

## 2. Associated policy issues and regulatory reporting

### Chapter Summary

This chapter describes the licence changes we are proposing to implement to give effect to wider policy issues we consulted on as part of TPCR. It also sets out our proposed changes to the framework for regulatory reporting.

### Questions

**Question 2.1: Do you have any comments on the proposed licence drafting?**

### Introduction

2.1. The process of the TPCR is wider than re-setting the revenue restrictions of the licensees. We consulted on a number of specific measures that in our view would enhance and strength the regulatory regime - including by putting in place measures to improve the basis upon which future price control reviews can be undertaken.

2.2. The specific areas where we consulted on associated policy issues affecting NGG NTS were:

- Development of output measures;
- Network investment planning (methodology and information); and
- Promoting competition in the provision of Operating Margins and System Support services.

2.3. These are discussed in turn below. The chapter then concludes with a discussion of our proposed changes to the framework for regulatory reporting.

### Development of output measures

2.4. One of the barriers we came across in undertaking this TPCR was the lack of output measures as reference points in assessing the cost forecasts submitted by the companies. We concluded that it was appropriate to oblige the companies to take steps to help address this information gap. This is reflected in the proposed drafting of Special Condition C13.

### Network investment planning

2.5. Another insight from the TPCR was the lack of clarity from NGG NTS on the basis upon which it planned investment in the network - and the related lack of clarity on the precise capability of the network. These are important questions for future price

reviews and for users of NGG NTS's network on an ongoing basis. We have therefore concluded that additional licence obligations should be put in place for NGG NTS to review and clarify the basis upon which it plans investment, and to provide better information on network capability to users of its transmission network.

### **Special Condition C11**

2.6. This new special condition will oblige NGG NTS to establish a transmission planning code. A key specific issue for review cited in the new licence condition in establishing the first transmission planning costs is the issue of Operating Margins.

### **Special Condition C24**

2.7. This new special condition will oblige NGG NTS to develop and publish a network model for the purposes of transparency over the development of the gas transmission system.

## **Facilitating competition in OM and System Support services**

2.8. As part of the review of NGG NTS's revenue restriction we reviewed the costs of the services that NGG NTS currently procures from its affiliated LNG storage business in respect of Operating Margins and locational System Support services. One conclusion we drew from this review was the need to ensure that NGG NTS took adequate and timely steps to test the market in respect of the long term provision of these services.

### **Special Condition 25**

2.9. This condition places a new obligation on NGG NTS to take steps to facilitate competition in the long term provision of OM and System Support services. We will need to make further amendments to ensure that the existing regulatory regime falls away after two years.

## **Regulatory reporting**

### **Cost Reporting and financial ring-fence**

2.10. As part of the DN sales process Ofgem introduced the annual price control reporting requirement and modified financial ring fence provisions. We intend to develop an additional section C special condition that will provide supplementary obligations to those obligations set out in Part A of the licence. The purpose of this condition is to bring the obligations in line with those for other transmission licensees.

**Revenue Reporting**

2.11. The licence has revenue reporting obligations embedded within the conditions - particularly Special Condition 8B. These obligations relate to the provision of both audited and forecast information.

2.12. We intend to supplement these obligations with provisions to ensure that information provided under them is accurate and complete. We therefore propose to amend C14 to capture all relevant forecast and historic information which may be provided at periods throughout the year. Furthermore we will also introduce a new condition (Special Condition C26) co-ordinating the provision of audited price control information.

2.13. The practical implications of this are being reviewed. There is ongoing commitment to further amendments.

## 3. Gas offtake

### Chapter Summary

This chapter describes the changes we are proposing to make to the licence of NGG NTS in respect of the detail of how NGG NTS' incentives for the delivery of offtake capacity operate.

### Questions

**Question 3.1: Do you have any comments on the proposed licence drafting?**

## Introduction

3.1. This chapter builds on the explanatory note issued in October 2006<sup>1</sup>, which provided a detailed explanation of the proposed licence modifications relating to the activities undertaken by NGG NTS in respect of its management of the provision of capacity for the offtake of gas from the NTS (gas exit). This chapter updates the explanation of the licence changes and particularly notes the amendments to the licence drafting since the October 2006 consultation.<sup>2</sup> The amendments have been made to take account of Ofgem's final proposals and the comments received on the October 2006 consultation.

3.2. The October 2006 explanatory note covered not just the NTS gas exit conditions, but also explained how Ofgem intended, more generally, to structure the licence conditions to implement the transmission price control. This updated explanatory note again puts the NTS gas exit conditions in the context of the overall licence conditions for the transmission price control, but detailed explanations of the contents of the other conditions are addressed elsewhere in this document.

## Proposed licence modifications relating to gas offtake

3.3. The licence modifications proposed in relation to gas exit are predominantly driven by the need to implement appropriate incentives and obligations for the duration of the next price control consistent with our current proposals for the TPCR. However, certain aspects of the drafting are contingent upon the implementation of enduring offtake reform, which is currently the subject of the Uniform Network Code (UNC) process.

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<sup>1</sup> 188/188/06 - NTS gas offtake: Proposals for licence modification drafting, Ofgem, 20 October 2006.

<sup>2</sup> The final proposals for NTS offtake issues are explained in detail in "Transmission Price Control Review: Final Proposals, Appendices", Ofgem, December 2006.

3.4. In December 2005 NGG NTS commenced a process of consultation and discussions with industry participants and, on 13 September 2006, it raised a UNC modification proposal to introduce the proposed NTS offtake arrangements. This is modification proposal 0116V, 'Reform of NTS Offtake Arrangements', ("proposal 0116V"). It envisages that the new arrangements will take effect from July 2007, with capacity offered from October 2010. We note that this proposal, and the alternative Modification Proposals raised, are subject to the UNC process and that nothing in this consultation can fetter the discretion of the Authority in considering this or any other modification proposal. However, in order to inform industry participants of the interaction of any such modification proposal and the provisions within the licence held by NGG NTS, we have outlined what the proposed licence modification drafting to accompany such reforms would look like.

3.5. The licence conditions which we propose to modify in order to implement our proposals at gas exit are as follows:

- Special Condition C8E (NTS gas exit incentives, costs and revenues) – a new condition that we propose to introduce as part of the restructuring of the current Special Condition C8B;
- Special Condition C8A (Revenue restriction definitions in respect of the NTS transportation owner activity and NTS system operation activity), which requires definitional changes consistent with the proposed drafting of Special Condition C8E;
- Special Condition C14 (Information to be provided to the Authority in connection with the transportation system revenue restriction in respect of the NTS transportation owner activity and NTS system operation activity) is subject to development as a result of changes proposed to ensure consistency in financial reporting and, as such, this condition remains under review.
- Special Condition C18 (Licensee's methodology for determining incremental exit capacity volumes) consistent with the potential introduction of enduring offtake arrangements;
- the potential removal of Standard Special Condition A55 (Enduring Offtake Arrangements); and
- the potential removal of Special Condition C17 (Exit Code Statement).

3.6. We discuss our proposals in relation to each of these licence conditions in turn below before briefly describing other exit related licence drafting issues. Licence drafting is provided for comment. These modification proposals are consistent with our Final Proposals and have taken into account comments received in response to our informal consultation which closed on 24 November 2006<sup>3</sup>.

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<sup>3</sup> 188/06 - [NTS gas offtake: Proposals for licence modification drafting](#), Ofgem, 20 October 2006.

**Special Condition C8E (NTS gas exit incentives, costs and revenues)**

3.7. The new Special Condition C8E will contain the provisions of the current Special Condition C8B that relate to gas exit where it is our proposal to retain these for the transitional period as well as introducing a number of new provisions in relation to incentives that would apply were enduring offtake reform to proceed.

3.8. As such the new Special Condition C8E is subdivided into four main paragraphs:

- Paragraph 1 derives the gas exit related allowed revenues and costs (SOExIRCt) that feed into the determination of the maximum SO revenue. This is then further sub-divided into the following incentives and cost categories:
- the buy-back and interruptions incentive;
- the proposed CLNG incentive;
- the exit capacity investment incentive;
- the long run contracting incentive;
- the non-obligated capacity incentive;
- a mechanism to cap incremental investment buy-back exposure; and
- an allowance for charges foregone.
- Paragraph 2 derives NTS gas exit revenues that feed into the determination of actual TO revenue (TORt) and actual SO revenue (SORt);
- Paragraph 3 outlines the capacity release obligations that will be imposed upon NGG NTS, which were included in paragraph 1(d)(iii) of the licence drafting presented as part of our previous informal October 2006 licence consultation on gas exit drafting;
- Paragraph 4 outlines the gas exit related statements that the licensee is obliged to provide to the Authority.

3.9. The table in Appendix 2 provides an overview of the proposed structure of Special Condition C8E and the applicability of each of the provisions of this condition to different periods within the next price control period.

**Derivation of SOExIRC**

3.10. Paragraph 1 of Special Condition C8E derives the gas exit related allowed revenues and costs (SOExIRCt) that feed into the determination of the maximum SO revenue.

3.11. Sub-paragraph 1(a) of Special Condition C8E provides the principal formula for the derivation of SOExIRCt. Each of the parameters defined as part of this formula are discussed in turn below.

**Buy-back and interruptions incentive (ExCBBIIRt)**

3.12. A buy-back and greater than 15 day interruptions incentive currently applies to NGG NTS. This is a sliding scale incentive (with a cap and collar) that establishes a target for the costs of interrupting sites greater than 15 days each year and a target

for buy-back costs. Under current arrangements, additional rebates are given to those sites that are interrupted for greater than 15 days each year. If the costs of these rebates and any capacity buy-backs undertaken by NGG NTS exceed the target that is set then NGG NTS bears a share of these costs.

3.13. In our June TPCR: Initial Proposals consultation<sup>4</sup> (June Proposals) and the subsequent September Proposals, we proposed that:

- the current buy-back and interruptions incentive should apply for the period until 30 September 2008;
- the greater than fifteen day interruptions element of the incentive should continue (in the form of a sliding scale incentive) for the duration of the transitional period until 30 September 2010; and then
- the incentive should cease to apply in the enduring period i.e. the period from 1 October 2010 onwards.

3.14. The drafting of sub-paragraph 1(b) therefore retains much of the drafting for the buy-back and interruptions incentive currently present within the NTS licence, however:

- the value of ExCBBIIRt is set to zero for the period from 1 October 2010 (or such date that the Authority may otherwise direct in writing); and
- for the period up to 30 September 2010 (or such date that the Authority may otherwise direct in writing), ExCBBIIRt is defined such that NGG NTS is able to recover relevant buy-back and interruptions costs (ExCBBICPt) but is subject to gains and losses around this cost-recovery level through the application of a sliding scale incentive where:
  - the component of relevant buy-back and interruptions costs (ExCBBICPt) which relates to buy-back actions takes a value of zero for all days from 1 October 2008 (or such date that the Authority otherwise directs in writing) – this reflects our proposal that the buy-back incentive be removed from this date leaving only the greater than 15 day incentive;
  - the greater than 15 day target and the incentive collar change on 1 October 2008 (or such date that the Authority otherwise directs in writing) consistent with our proposals; and
  - a cap is no longer applied to the sliding scale incentive in the event that the relevant costs incurred (ExCBBICPt) are less than the defined target (ExCBBIIIt) as such a provision is not necessary<sup>5</sup>.

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<sup>4</sup> TPCR 2007-2012 Initial Proposals, Ofgem, June 2006 (Ref No. 104/06)

<sup>5</sup> For the period up to 30 September 2008, the cap is defined to be equal to the incentive target, however, given that costs can only be positive, the maximum incentive revenue through out-performing the target is the target subject to the 75% sharing factor, which by definition, will be less than the target so the cap can never be binding. Similarly, in the period from 1 October 2008 to 30 September 2010, the target is defined to be zero and, as such, out-performing the target is not possible.

3.15. Enduring offtake reform if implemented would take effect part way through a formula year (October). Therefore, in that first year, the incentive schemes in the licence would only cover 6 months even though they have been developed as full year incentives. The current licence drafting proportions the non-obligated incremental incentive parameters, e.g. the cap, if enduring offtake reform is introduced part way through a formula year. Ofgem would welcome views on whether the licence should pro-rate the parameters of the other incentive schemes for interruption and buyback in a similar way to ensure that the power of the incentives is the same whether they apply for some or all of a formula year

### **CLNG target (ExCITt)**

3.16. The CLNG incentive is intended to ensure that NGG NTS uses LNG facilities efficiently when managing network constraints. Due to NGG NTS's ownership of constrained LNG storage facilities (through National Grid LNG), the scheme is currently separate from the exit investment scheme with no caps and collars and 100% sharing factors. This structure eliminates the scope for distorting behaviour between the regulated gas transmission business and the LNG businesses that are wholly owned by the National Grid Group.

3.17. In our Final Proposals, we indicated that the constrained LNG (CLNG) incentive that currently applies to NGG NTS should be retained in its current form with the incentive target value updated.

3.18. In order to replicate the effect of a sliding scale incentive with 100% sharing factors and no caps or collars, it is simply necessary to define a target for CLNG costs. This is done in sub-paragraph 1(c), with the targets consistent with those included within our Final Proposals. Any deviations of out-turn costs from the defined target are borne in full by the licensee.

3.19. In addition, reflecting our final proposals on CLNG, we believe that it would be appropriate to modify the definition of RCOMt such that any revenues from the sale of such gas are excluded (and therefore retained by NGG NTS) and therefore the costs of procuring gas for CLNG can be recovered by the retention of revenues from the locational sale of gas elsewhere in the network as a result of the use of CLNG.

### **Exit capacity investment incentive (ExCIIRt)**

3.20. In our Final Proposals, we indicated that the delivery of capacity above baseline levels would be remunerated through the application of pre-specified revenue drivers as appropriate.

3.21. We proposed:

- a zonal revenue driver for all capacity increments in the south west quadrant that are less than 15GWh/day in size; and

- nodal, project specific revenue drivers for all projects above this threshold regardless of their location.

3.22. The licence drafting in sub-paragraph 1(d) implements this policy through the specification of two variables (both of which are indexed for inflation):

- $ExCIIRtprojspec$ : which determines allowed revenue for specific, anticipated projects that are greater than or equal to 15GWh/day; and
- $ExCIIRtswquad$ : which determines allowed revenue for smaller investments yielding capacity increments of less than 15GWh/day in the south west quadrant.

3.23. We now provide high-level definitions of these two parameters at the start of paragraph 1(d).

3.24.  $ExCIIRtprojspec$  is defined as the sum across all anticipated projects of the applicable project specific revenue drivers. A variable  $CDEL_{p,t}$ , that either takes a value of zero or one, determines which revenue drivers are applicable in any given formula year with this variable taking a value of one in formula years  $t$ ,  $t + 1$ ,  $t + 2$ ,  $t + 3$  and  $t + 4$  if the anticipated project ( $p$ ) is delivered in formula year  $t$  following the receipt of an appropriate long term user signal (as specified in the Exit Capacity Release Methodology Statement pursuant to Special Condition C18). As such, the revenue drivers apply on a five year rolling basis from contractual delivery as previously outlined in our TPCR proposals.

3.25. The relevant project specific revenue drivers are provided in a table, and each of the projects is defined to ensure that the lump sum allowance specified for the project is not applied to similar projects of differing scale or scope, and is not applied if a revenue driver has already been payable in respect of the same incremental capacity.

3.26. Consistent with our Final Proposals, an input price indexation factor is applied to each project, with the relevant factor determined by the formula year in which the relevant incremental capacity is delivered. These indexation factors are based upon assumed real changes in input prices for steel and contractors. The factors included within the licence assume that, if incremental capacity is delivered in year  $t$ , then the revenue driver that is then applied on a five year rolling basis should reflect 20% of the relevant index for year  $t-2$  and 80% of the relevant index for year  $t-1$ , consistent with the assumed profile of capital expenditure prior to project delivery.

3.27.  $ExCIIRtswquad$  is defined to be non-zero where the incremental capacity delivered, in a given formula year, across all nodes in the south west quadrant is less than 15 GWh/day. In such an instance,  $ExCIIRtswquad$  is defined to be equal to the zonal revenue driver specified multiplied by the appropriate incremental exit capacity.

3.28. The appropriate volume of incremental exit capacity is defined separately for the periods preceding and following 1 October 2010 (or such date that the Authority otherwise directs in writing):

- prior to 1 October 2010, incremental capacity can be remunerated via the zonal revenue driver if the licensee has either:
- received a specific user commitment; or
- the Authority has so determined (this latter provision addresses the fact that investment may be appropriate absent a specific user commitment in advance of the introduction of a full user commitment model); and
- on or after 1 October 2010, it is made clear that “NTS obligated incremental exit flat capacity” (the definition of which is provided in Special Condition C8A) can be remunerated through this mechanism.

3.29. In both cases:

- clarification has been provided that the relevant incremental capacity is only capacity to which a revenue driver has not previously been applied;
- a variable RDELZ,t that either takes a value of zero or one is specified such that the revenue driver, again, applies on a five year rolling basis from contractual delivery as previously outlined in our TPCR proposals; and
- consistent with our Final Proposals, and the drafting for project specific revenue drivers, an input price indexation factor is applied, with the relevant factor determined by the formula year in which the relevant incremental capacity is delivered.

3.30. We note that the capacity release obligations that were previously included in paragraph 1(d)(iii) as part of the earlier draft of proposed licence modifications consulted upon in October / November have now been moved to form a separate paragraph 3.

### **Long run contracting incentive (ExLRCIRt)**

3.31. In our Final Proposals, we indicated that, in the enduring period, there should be an upwards adjustment of a number of nodal baselines in the south west quadrant above the physical capability of the network, where such sites had historically interruptible status. We proposed that such adjustments should be accompanied by an additional revenue allowance to remunerate efficiently incurred contracting costs at the relevant sites. In the September Proposals, we proposed a value for the target and stated our view that 50% sharing factors should be applied to the extent that NGG NTS deviates from the target determined.

3.32. Sub-paragraph 1(e) implements this policy by defining the parameter ExLRCIRt such that it allows the recovery of the costs incurred with respect to the delivery of baseline capacity at the relevant sites with additional up-side or down-side determined by a sliding scale incentive whereby the licensee bears 50% of all deviations from the target level of costs.

**Non-obligated capacity incentive (ExNOCIRt)**

3.33. In our Final Proposals, we proposed that the release of non-obligated capacity by NGG NTS should be incentivised through a sliding scale incentive, with a zero target, that would allow NGG NTS to retain 50% of revenues from the sale of:

- non-obligated incremental flat capacity;
- non-obligated incremental flexibility capacity; and
- interruptible capacity sold at the day ahead stage.

3.34. This policy is implemented through the determination of the parameter ExNOCIRt in sub-paragraph 1(f) which is derived through a sliding scale incentive.

3.35. We have also provided additional drafting to clarify the applicability of the £20m annual cap where the regime is only in place for part of a formula year. For example, the drafting states that the cap should be pro-rated. As such, if the enduring regime came into place on 1 October 2010, and therefore applied for half of a formula year, the relevant cap should be £10m.

3.36. Since the final proposals NGG NTS has suggested that the revenues from the sale of non-obligated incremental flexibility capacity should be calculated as the volume sold multiplied by a reference price rather than the market price from the proposed auctions of such capacity. As was indicated in our Final Proposals, Ofgem shares the concerns of industry participants with respect to the baseline level of flexibility for the enduring offtake arrangements. In view of these concerns, we believe that it would be preferable to set the flexibility capacity element of this incentive around a reference price rather than a market based price. Ofgem is proposing a £4,000 reference price<sup>6</sup> for each mcm of capacity sold each day by NGG NTS. We would note that when further information is revealed regarding available flexibility levels it would be preferable to revert to an incentive based around market prices, similar to that which operates in the entry capacity regime.

3.37. Going forward, Ofgem will monitor the availability of incremental non-obligated flexibility capacity to assess whether the baselines proposed are appropriate to the system capabilities in the enduring regime (if implemented). We also intend to monitor the release of flexibility carefully in the light of the NGG NTS licence obligation to operate an economic, efficient and coordinated system. Further, if Ofgem was concerned that the baselines were inappropriate and set at a level which does not fully reflect physical availability, it would review whether it should propose to amend the baselines.

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<sup>6</sup> We note that any rewards are subject to a 50% sharing factor.

**Cap on incremental investment buy-back exposure (ExIBBCt)**

3.38. In our September Proposals, we indicated in our Final Proposals that investment related buy-back costs should be treated as excluded revenue. However, following further consideration of the potential exposure of NGG NTS to buy-back actions associated with incremental investment, we stated that an absolute cap on such exposure of £36m per annum would be appropriate in respect of gas exit.

3.39. This policy is implemented through the determination of the parameter ExXSIBBCt in sub-paragraph 1(g). However, we have provided clarification of the applicability of the £36m annual cap where the regime is only in place for part of a formula year. For example, the drafting states that the cap should be pro-rated. As such, if the enduring regime came into place on 1 October 2010, and therefore applied for half of a formula year, the relevant cap should be £18m. As noted above in paragraph 3.15, we would welcome views on whether the cap should be provided in this way.

3.40. Furthermore, and consistent with our Final Proposals, the drafting has been expanded relative to our previous consultation to reflect the implementation of a monthly cap on exposure of £4m and to clarify that the unit price used to inform the derivation of buy back costs should not exceed the administered buy back price.

**Charges foregone (ExNTSSICt)**

3.41. In the current NTS licence, the total accrued value in respect of charges foregone as a result of the discount to capacity charges offered to interruptible customers feeds into the assessment of actual TO revenues such that TO charges are determined as if such charges had not been foregone. However, an equal and opposite allowance for charges foregone is made such that this amount feeds into allowed SO revenue for the licensee such that these costs can be recovered through the SO business. In addition, there is at present an incentive upon the level of charges foregone such that deviations for an assumed target increase or decrease the allowed revenue of the licensee.

3.42. In our June Initial Proposals consultation and the subsequent September Proposals, we proposed to remove the incentive in place in relation to charges foregone. This remained unchanged in our final proposals and, as such, no incentive is included in the licence drafting presented. However, it remains necessary for the level of charges foregone to feed into the allowed SO revenue until implementation of the enduring offtake regime (at which time the principle of charges foregone and the interruptible discount are assumed to no longer apply). As such, sub-paragraph 1(h) retains the drafting currently within the NTS licence in this regard, setting the level of charges foregone (ExNTSSICt) to zero for all days from 1 October 2010 onwards (or such date that the Authority otherwise directs in writing).

### **Derivation of NTS gas exit revenues**

3.43. Paragraph 2 of Special Condition C8E derives NTS gas exit revenues that feed into the determination of actual TO revenue (TORt) and actual SO revenue (SORt).

### **NTS transportation owner revenues (TOExRt)**

3.44. Sub-paragraph 2(a) derives the gas exit revenues (TOExRt) that feed into the determination of actual TO revenues. As is the case in the NTS licence at present, TOExRt is defined as the sum of:

- TOExRFt, which, in the drafting proposed, represents gas exit related TO revenues in the period prior to 1 October 2010 (or such date that the Authority otherwise directs in writing);
- TOExNTSSICt, which is the accrued value of charges foregone, which is derived in sub-paragraph 1(g) and discussed above; and
- TOREVBExCt which, in the drafting proposed, represents gas exit related TO revenues in the period from 1 October 2010 (or such date that the Authority otherwise directs in writing).

3.45. TOExRFt is derived in sub-paragraph 2(a)(i). The derivation of this term has been refined relative to the drafting currently within the NTS licence, as the definition of nodal baselines for the three capacity products in the period prior to 1 October 2010 (NTS exit flat capacity<sup>7</sup>, NTS exit flow flexibility<sup>8</sup>, and NTS exit shipper capacity<sup>9</sup>) allows the term to be specified as the sum of:

- revenues in respect of the provision of NTS baseline exit shipper capacity (TREVBSct);
- revenues in respect of the provision of NTS baseline exit flat capacity (TREVExCt); and
- revenues in respect of the provision of NTS baseline exit flow flexibility (TREVBFFt).

3.46. TOREVBExCt, is derived in sub-paragraph 2(a)(ii). The derivation of this term has, again, been refined relative to the drafting within the NTS licence (which is currently dormant) as it is our proposal that the obligation to make baseline capacity available in the enduring period will be up to and including on the gas day. As such, we do not believe that it is either appropriate or necessary to deduct revenues from on the day sales of baseline capacity as is currently the case.

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<sup>7</sup> In the transitional period, this is the flat capacity product offered at GDN offtakes

<sup>8</sup> In the transitional period, this is the flat capacity product offered at GDN offtakes

<sup>9</sup> This is a transitional period product offered at TCC offtakes in place of the two separate products offered at GDN offtakes.

**NTS system operation revenues (SOExRFt)**

3.47. Sub-paragraph 2(b) derives the gas exit revenues (SOExRFt) that feed into the determination of actual SO revenues. SOExRFt is defined as the sum of:

- SO revenues in the period up to 1 October 2010 (or such date that the Authority otherwise directs in writing), which are defined to be gas exit revenues from the sale of NTS exit flat capacity, NTS exit flow flexibility and NTS exit shipper capacity net of revenues captured by the term TOExRFt which is discussed above, and therefore include revenues for the sale of incremental and interruptible capacity; and
- SO revenues in the period from 1 October 2010 (or such date that the Authority otherwise directs in writing), which are defined to be the sum of:
  - revenues from the sale of NTS obligated incremental exit flat capacity;
  - revenues from the sale of NTS obligated incremental exit flow flexibility; and
  - revenues from the sale of NTS non-obligated exit capacity (the composition of which was discussed above in relation to the non-obligated capacity incentive).

3.48. The definition of the terms quoted above are discussed further in our discussions of the modifications proposed to Special Condition C8A below.

**Capacity release obligations**

3.49. A new paragraph 3 has been inserted relative to the proposed modifications consulted upon in October / November to include the appropriate capacity release obligations applicable to the licensee in the enduring period, which were previously included within paragraph 1(d)(iii). These obligations are consistent with our Final Proposals, and as such impose the following obligations:

- to release baseline capacity up to the end of the gas day – this provides additional clarification relative to the drafting previously consulted upon which stated that the obligation applied “up to and including the gas day”;
- to release obligated incremental capacity for which an appropriate user commitment has been received up to the end of the gas day – again, this provides additional clarification relative to the drafting previously consulted upon which stated that the obligation applied “up to and including the gas day”;
- to substitute capacity release obligations (baselines) between nodes such that the level of obligated incremental capacity that requires additional remuneration is minimised (the substitution obligation); and
- to revise capacity release obligations (baselines) upwards in the event that the release of obligated incremental entry capacity increases the availability of NTS exit capacity.
- We have added an additional obligation following consideration of comments on our October 2006 consultation. The new drafting requires NGG NTS to use reasonable endeavours to revise capacity release obligations (baselines) for NTS exit capacity flexibility in response to revisions of capacity release obligations for NTS exit flat capacity.

**Statements required from the licensee**

3.50. Paragraph 4 outlines the gas exit related statements that the licensee is obliged to provide to the Authority. These include the following:

- statement of actual interruption;
- statement of incremental investment in the transitional period;
- methodology statement for baseline revision;
- request for baseline revision; and
- statement of incremental obligated capacity in the enduring period.

3.51. Each of these statements are considered in turn below.

*Statement of actual interruption*

3.52. Sub-paragraph 4(a) states that the licensee shall be obliged to publish daily statements of actual interruption. This obligation currently applies to NGG NTS and it is our intention to retain this obligation in its current form for the duration of the forthcoming price control period.

*Statement of incremental investment in the transitional period*

3.53. Sub-paragraph 4(b) states that the licensee shall be obliged to provide the Authority with a written statement of any NTS incremental exit capacity that is scheduled for delivery within the transitional period (from 1 October 2008 to 30 September 2010 (or such dates that the Authority otherwise directs in writing)) which leads to depreciation, capex or financing costs being incurred within the next price control period.

3.54. Where the licensee has not received an explicit and appropriate user commitment, the licensee must explain the basis upon which it has reached the view that demand will be sufficient to justify the provision of such NTS exit capacity. In such cases, the Authority shall consider such information and shall determine whether the NTS exit capacity concerned may be treated, for revenue driver purposes, as if such a user commitment had been received.

3.55. Since we last consulted upon the modifications proposed in this regard, we have provided some clarification to the drafting.

*Methodology statement for baseline revision*

3.56. Sub-paragraph 4(c) states that the licensee shall be obliged to provide the Authority with a methodology statement for exit baseline revision setting out the methodology by which it will determine its proposals for the revision of baselines within the enduring period pursuant to its obligations in this regard (as discussed above).

3.57. The initial statement and revisions to such a statement shall be subject to a consultation process. The licensee will also be obliged to comply with the methodology outlined in this statement in performing baseline revisions.

3.58. We would welcome views on whether the licence should state methodology objectives for such a statement and, if so, what these should be.

3.59. Since we last consulted upon the modifications proposed in this regard, we have provided some clarification to the drafting.

#### *Request for baseline revision*

3.60. Sub-paragraph 4(d) states that the licensee shall be obliged to provide the Authority with a written statement of any proposed exit baseline revisions setting out the basis for such revisions consistent with its obligations in this regard (as discussed above). The Authority shall consider such information and shall determine whether to consent to the revisions proposed. Following the granting of any such consent, the licensee shall publish an "NTS exit baseline statement" incorporating such revisions. We note that the initial baselines are set out in "Schedule A: NTS output measures for the price control".

3.61. Since we last consulted upon the modifications proposed in this regard, we have provided some clarification to the drafting.

#### *Statement of incremental obligated capacity in the enduring period*

3.62. Sub-paragraph 4(e) states that the licensee shall be obliged to provide the Authority with a written statement, each year, of any proposed NTS obligated incremental exit capacity in the enduring period. Such a statement shall require the licensee to state the basis upon which the licensee has reached the view that the demand triggering such NTS obligated incremental capacity cannot be satisfied in full by the substitution or revision of baselines in order for the Authority to establish compliance with the obligations to substitute or revise baselines (as discussed above).

3.63. Since we last consulted upon the modifications proposed in this regard, we have provided some clarification to the drafting.

#### **Interaction with enduring offtake reform**

3.64. Where possible, the licence drafting of Special Condition C8E has been constructed such that, should enduring offtake reforms not proceed, or proceed such that they apply to a period other than the period from 1 October 2010 onwards, the Authority would be able to direct a later date for the introduction of such contingent licence drafting, as appropriate. However, as the legal drafting for any such

modification proposal develops, it may be necessary to refine the licence drafting proposed, particularly where the drafting references the UNC.

### **Special Condition C8A (Revenue restriction definitions in respect of the NTS transportation owner activity and NTS system operation activity)**

3.65. It will be necessary to modify Special Condition C8A within the current NTS licence to acknowledge definitions that are no longer required as well as new terms introduced as a result of the modifications proposed to Special Conditions C8B to C8F.

3.66. In this section, we consider the modifications that are required to Special Condition C8A as a result of the proposed drafting of Special Condition C8E (discussed above).

3.67. As stated earlier, many of the changes outlined to Special Condition C8E are contingent upon the progression of NTS enduring offtake reform. In the event that the enduring period provisions within Special Condition C8E do not become active, then the associated definitions with Special Condition C8A will lie dormant. However, it should also be noted that, as the legal drafting of any UNC modification proposal to implement enduring offtake reform is developed, it will be necessary to ensure that the terms used in both Special Condition C8A and Special Condition C8E remain consistent with the drafting of the UNC.

3.68. We first discuss exit related terms that are no longer required within Special Condition C8A before discussing new terms that we propose to introduce and terms that we propose to modify.

3.69. The modifications to Special Condition C8A only consider the modifications needed with regards to gas offtake related changes.

### **Exit related terms that we propose to remove**

3.70. As a result of our proposed modifications to the exit related provisions of what is currently Special Condition C8B, it is no longer necessary to include definitions of the following terms within Special Condition C8A:

- “DM connected system exit point”, “DM supply meter point”, “NDM connected system exit point”, and “NDM supply meter point”: which are no longer required as these terms currently feed into the charges foregone and investment incentive which we are not proposing to apply during the next price control period;
- “exit capacity curtailment rights”: which has been deleted as this was performing the same function as “NTS exit capacity curtailment rights” and was therefore unnecessary;
- “NTS baseline firm exit capacity”: which is no longer needed as baselines are specified for the separate NTS exit capacity products applicable during the next price control period; and

- “NTS baseline interruptible exit capacity”: which is no longer needed as interruptible baselines are not proposed.

### **New exit related terms that we propose to introduce**

3.71. As a result of our proposed drafting for Special Condition C8E, as discussed above, it is necessary to introduce the following terms into Special Condition C8A:

- “NTS baseline exit flat capacity release obligations” and “NTS baseline exit flow flexibility release obligations”: to denote the capacity release obligations represented by the baselines defined for the enduring period to which the substitution obligation applies;
- “NTS exit baseline statement”: to denote the statement of baselines as set out in our Final Proposals or subsequently amended (with the Authority’s consent) through application of the substitution obligation or following relevant entry investments that impact upon exit capacity<sup>10</sup>;
- “NTS firm exit flat capacity”, “NTS firm exit flow flexibility” and “NTS firm exit shipper capacity”: to denote the firm nature of the products offered and allow clarity in the drafting that the baselines and capacity release obligations relate to the contractual delivery of firm capacity;
- “NTS obligated incremental exit flat capacity” and “NTS obligated incremental exit flow flexibility”: to denote incremental capacity in the enduring period which has an appropriate user commitment and which the licensee is therefore obliged to release. Further, we note that since we consulted upon these proposed modifications in October / November, we have amended these definitions to remove some circularity in the drafting by removing the reference to the capacity release obligations;
- “NTS non-obligated exit capacity”: to denote all NTS exit capacity that the licensee does not have an obligation to release;
- “NTS non-obligated incremental exit flat capacity” and “NTS non-obligated incremental exit flow flexibility”: to denote two of the types of NTS non-obligated exit capacity, namely incremental exit capacity for which an appropriate user signal has not been received; and
- “NTS short term interruptible capacity”: which denoted NTS interruptible exit capacity excluding capacity that is subject to exit capacity curtailment rights as a result of long term contracting to buy-back capacity in order to minimise or avoid the need for investment to deliver obligated capacity.

3.72. The concept of “NTS obligated incremental exit flow flexibility” is acknowledged in the proposed licence drafting even though, in the enduring regime, it is not expected that NGG NTS will be able to offer incremental flow flexibility in the long term over and above the baseline levels specified. The provision of such incremental capacity would be addressed on a case by case basis and subject to Authority consent, as acknowledged by the definition of this term, as well as requiring the

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<sup>10</sup> NGG NTS will be obliged to publish any revisions to this statement.

specification of revenue drivers. However, the concept has been introduced into the licence drafting at this stage to cater, at least partially, for such situations should they arise. The introduction of such a term also allows us to be clear in specifying the definition of “NTS non-obligated incremental exit flow flexibility” which allows the release of additional flexibility capacity within investment lead times to be incentivised.

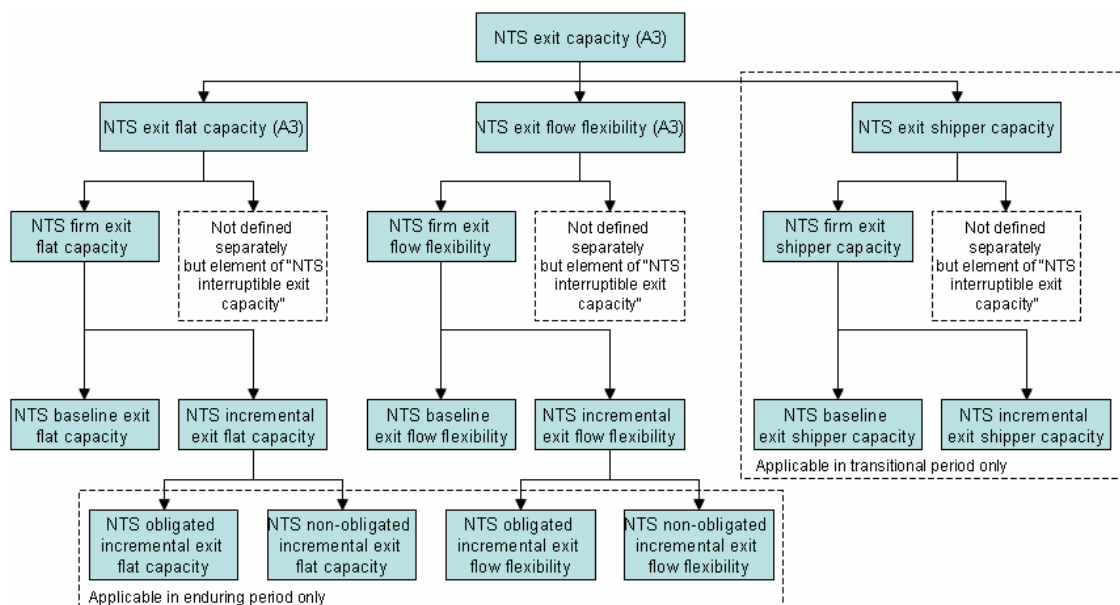
**Exit related terms that we propose to modify**

3.73. As a result of our proposed drafting for Special Condition C8E, as discussed above, we propose to modify the definitions of the following terms:

- “NTS baseline exit flat capacity”, “NTS baseline exit flow flexibility”, and “NTS baseline exit shipper capacity” such that it is clear that such capacity is firm in nature and such that the definitions reference the “NTS exit baseline statement” rather than Schedule A;
- “NTS incremental exit flat capacity”, “NTS incremental exit flow flexibility”, and “NTS incremental exit shipper capacity” such that it is clear that such capacity is firm in nature;
- “NTS exit capacity curtailment rights”: harmonising the definition applied with that for the removed term “exit capacity curtailment rights”; and
- “NTS incremental exit capacity” has been redefined as the sum of “NTS incremental exit flat capacity”, “NTS incremental exit flow flexibility” and “NTS incremental exit shipper capacity”.

3.74. The proposed hierarchy of exit capacity product definitions is illustrated in Figure 1 below.

**Figure 1: Proposed hierarchy of exit capacity product definitions**



3.75. As noted in the diagram above, certain definitions, which also apply within the GDN licences are defined in Standard Special Condition A3 (Definitions and Interpretation).

**Special Condition C18 (Licensee's methodology for determining incremental exit capacity volumes)**

3.76. We have considered what changes may be necessary to Special Condition C18, particularly in the light of the potential introduction of enduring offtake reform. Given that NGG NTS's current proposals for reform envisage a framework whereby all capacity booked and released in the long-term, over and above users' prevailing rights, requires a user commitment regardless of whether it is above or below baseline levels, it is our view that the reference of the statement to "incremental" capacity will become less meaningful. Rather, we believe that it would be more helpful if NGG NTS were obliged to provide a methodology statement outlining the principles that will be applied with respect to the release of all capacity. As such, we propose to:

- rename Special Condition C18 such that it is called "Licensee's methodology for determining the release of exit capacity volumes";
- remove paragraph 1 which currently provides definitions of "incremental exit capacity" and "initial volume allocation" and remove "incremental" references which we believe are no longer necessary given the change in focus of this statement; and
- ensure that a methodology statement is in place on the first day of the next price control period, and will have been subject to consultation with gas shippers and DN operators, and that it is resubmitted in April, rather than July, each year in advance of the proposed capacity booking window in July each year.

3.77. Furthermore, we propose to amend the requirement, in what is now paragraph 2, such that the statement from appropriate auditors is required only if the Authority so directs rather than being required as a default, unless the Authority otherwise consents. This follows submissions from NGG NTS stating that such auditor statements are difficult and expensive to obtain.

3.78. Since we last consulted upon the modifications proposed in this regard, we have provided some clarification to the drafting, consistent with the clarifications proposed to paragraph 4(c).

**Standard Special Condition A55 (Enduring Offtake Arrangements)**

3.79. Standard Special Condition A55 was introduced in 2005 and requires the NTS and GDN licensees to use their best endeavours to implement enduring offtake reform. As such, should enduring offtake reform be implemented this condition will no longer be necessary and we therefore propose its deletion.

**Special Condition C17 (Exit Code Statement)**

3.80. Special Condition C17 requires NGG NTS to submit an exit code statement which provides a description of the services provided and revenue received by the licensee's NTS activity and DN activity and therefore seeks to achieve clarity in the services and revenues shared between the NTS and GDN activities.

3.81. As part of the DN sales licence consultations in 2005, we stated our view that the requirements of this condition will cease to be necessary once enduring NTS exit arrangements have been implemented as there will be a transparent, external NTS-DN interface that will remove the need for publication of such a statement. We continue to hold this view and, as such, propose the deletion of this condition in the event that enduring offtake reform is implemented.

## Appendices

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## Appendix 1 - Consultation Response and Questions

1.1. Ofgem would like to hear the views of interested parties in relation to any of the issues set out in this document.

1.2. We would especially welcome responses to the specific questions which we have set out at the beginning of each chapter heading and which are replicated below.

1.3. Responses should be received by 16 February 2007 and should be sent to:

Robert Hull  
Director - Transmission  
Office of Gas & Electricity Markets  
9 Millbank  
London  
SW1P 3GE

Tel: 020 7901 7050  
Email: [tpcr.responses@ofgem.gov.uk](mailto:tpcr.responses@ofgem.gov.uk)

1.4. Unless marked confidential, all responses will be published by placing them in Ofgem's library and on its website [www.ofgem.gov.uk](http://www.ofgem.gov.uk). Respondents may request that their response is kept confidential. Ofgem shall respect this request, subject to any obligations to disclose information, for example, under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004.

1.5. Respondents who wish to have their responses remain confidential should clearly mark the document/s to that effect and include the reasons for confidentiality. It would be helpful if responses could be submitted both electronically and in writing. Respondents are asked to put any confidential material in the appendices to their responses.

1.6. Next steps: Having considered the responses to this consultation, Ofgem intends to continue to engage the transmission licensees in developing the drafting. The conclusion of the process will be a further consultation in late February and the publication of our statutory licence consultation in March/April 2007. Should the licensees accept the provisions of the statutory consultation, we will be issuing directions to modify the NGG NTS licence in April/May 2007.

**CHAPTER: 1**

**Question 1.1:** Do you have any comments on the proposed licence drafting?

**CHAPTER: 2**

**Question 2.1:** Do you have any comments on the proposed licence drafting?

**CHAPTER: 3**

**Question 3.1:** Do you have any comments on the proposed licence drafting?

## Appendix 2 - Structure of Special Condition C8E

Provisions of Special Condition C8E		1/4/07 – 30/09/08	1/10/08 – 30/09/10	1/10/10 – 31/03/12	Comments
1. NTS system operation exit incentives and costs (SOExIRC)	(a) Principal formula	✓	✓	✓	High level formula outlining derivation of SOExIRC.
	(b) Buy-back and interruptions incentive revenue (ExCBBIIIR)	✓	✓	-	Retention of the buy-back and interruptions incentive for the period to 30 September 2008, with the interruptions element of the incentive retained for the period from 1/10/08 to 30/09/10.
	(c) Constrained storage target (ExCIT)	✓	✓	✓	Applies throughout the next price control period.
	(d) Exit capacity investment incentive revenue (ExCIIR)	✓	✓	✓	Applies throughout the next price control period with different trigger mechanisms applying prior to introduction of the enduring period for zonal revenue drivers.
	(e) Long run contracting incentive revenue (ExLRCIR)	-	-	✓	Applies from the enduring period only.
	(f) Incentive revenue from sale of NTS non-obligated exit capacity (ExNOCIR)	-	-	✓	
	(g) Cap on incremental investment buy-back exposure (ExXSIBBC)	-	-	✓	

Provisions of Special Condition C8E		1/4/07 – 30/09/08	1/10/08 – 30/09/10	1/10/10 – 31/03/12	Comments
	(g) Charges foregone (ExNTSSIC)	✓	✓	-	Applies until 30/09/10.
2. NTS gas exit revenues	(a) NTS transportation owner revenues (TOExR)	✓	✓	✓	Applies throughout the next price control period, but separate terms defined for the periods up to 1 October 2010 and beyond.
	(b) NTS system operation revenues (SOExRF)	✓	✓	✓	
3. Capacity release obligations		-	-	✓	Apply to the enduring period only.
4. Statements required from the licensee	(a) Statement of actual interruption	✓	✓	✓	Applies throughout the next price control period.
	(b) Statement of incremental investment in the transitional period	-	✓	-	Applies to the transitional period (i.e. from 1/10/08 to 30/09/10) only.
	(c) Methodology for baseline revision	-	-	✓	These statements relate to capacity in the enduring period only. However, given the length of investment lead times, the obligations to provide such statements apply for the duration of the next price control period.
	(d) Annual report on baseline revision	-	-	✓	
	(e) Statement of obligated capacity in the enduring period	-	-	✓	

## 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.<sup>11</sup>

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 accordingly<sup>12</sup>.

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 them<sup>13</sup>; and
- The interests of individuals who are disabled or chronically sick, of pensionable age, with low incomes, or residing in rural areas.<sup>14</sup>

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:

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<sup>11</sup> entitled "Gas Supply" and "Electricity Supply" respectively.

<sup>12</sup> 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.

<sup>13</sup> 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.

<sup>14</sup> The Authority may have regard to other descriptions of consumers.

- Promote efficiency and economy on the part of those licensed<sup>15</sup> under the relevant Act and the efficient use of gas conveyed through pipes and electricity conveyed by distribution systems or transmission systems;
- 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 Regulation<sup>16</sup> 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.

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<sup>15</sup> or persons authorised by exemptions to carry on any activity.

<sup>16</sup> Council Regulation (EC) 1/2003

## Appendix 4 - Glossary

### B

#### Baseline

Baselines define the reference levels of capacity that the transmission licensee is to release. Baselines also determine the levels above (or below) which incremental capacity is defined.

#### Baseline Capital Expenditure

Baseline capital expenditure is the total amount of capex required in association with the baseline. It includes both load related capex and non-related capex.

### C

#### Capital Expenditure (Capex)

Expenditure on investment in long-lived transmission assets, such as gas pipelines or electricity overhead lines.

#### Compound Annual Reduction (CAR)

Also known as Compound Annual Growth Reduction (CAGR). The cumulative year on year rate applied to an investment or other part of a company's activities over a multiple-year period.

### D

#### Distribution Price Control Review (DPCR)

The price control review for the electricity distribution network operators conducted in 2003 & 2004. The resulting price control covers the years 2005 to 2010.

#### Distribution Network Operators (DNOs)

Holders of electricity distribution licences. Licences are granted for specified geographical areas. Currently in Great Britain there are seven companies who own the fourteen licensed distribution areas.

### E

#### Early Retirement Deficit Costs (ERDC)

ERDCs are the costs of providing the additional pension benefits payable to a scheme member who retires before normal retirement date as a result of re-organisation or redundancy, over and above the benefits to which such a member would be entitled if he retired voluntarily at the same date. The rules of both the ESPS and the LGPS provide for the automatic enhancement of benefits to which a member becomes entitled on taking early retirement as a result of re-organisation or redundancy. Principal employer companies have often in the past used a pension fund surplus to cover part or all of these additional costs, subject to agreement with the trustees of the scheme. In the absence of agreement by the trustees, the employer must make additional contributions to the pension fund to cover the additional liability.

#### [Electricity Supply Pension Scheme \(ESPS\)](#)

A Retirement Benefit Scheme based upon benefits paid as a proportion of final salary. The Scheme is an exempt approved scheme (ICTA'88) and is subject to a trust document. The "Group" has many principal employers and is organised and defined by a set of rules, trustees and produces accounts annually and actuarial valuations at least every 3 years (triennially). The scheme is principally for people working in the Electrical Utility Industries. This scheme is one of the 26 separate tranches each actuarially independent.

### **F**

#### [Front Office Management Services Agreed \(FOMSAs\)](#)

An agreement between the gas distribution business retained by National Grid Gas plc and the IDNs with regards to the provision of certain IT services.

#### [Forecast Business Plan Questionnaire \(FBPQ\)](#)

Expenditure information requested by Ofgem from the licensees relating to the period from 2005/06 to 2011/12.

### **G**

#### [Gas Distribution Networks \(GDNs\)](#)

Gas Distribution Networks, of which there are eight, four of which are owned by National Grid Gas plc, and four of which were sold by Transco plc (now National Grid Gas plc) to third party owners on 1 June 2005.

#### [Gas Distribution Price Control Review \(GDPCR\)](#)

The review of the price control applying to gas distribution networks. The review will extend the existing price control for the year 2007-08 and reset the control for the period commencing 1 April 2008.

#### [Gas Transmission Charging Methodology Forum \(GTCMF\)](#)

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A dedicated forum, established in January 2006, to allow National Grid NTS to provide information to the gas industry on its ongoing review of its Transportation Charging Methodology and other relevant charging methodologies and issues, and to provide an opportunity for users' views to be represented and discussed.

## H

### Historical Business Plan Questionnaire (HBPQ)

Expenditure information requested by Ofgem from the licensees relating to the period from the year before their most recent five-year full price control until 2004/05.

## I

### Independent Distribution Networks (IDNs)

Gas Distribution Networks which were sold to third party owners by Transco plc (now National Grid Gas plc) on 1 June 2005. There are four such network companies, which are: Northern Gas Networks Ltd, Scotland Gas Networks plc, Southern Gas Networks plc and Wales & West Utilities Ltd.

### Information Quality Incentive Mechanism

A form of incentive design adopted by Ofgem as part of the DPCR which provided companies with the potential for greater rewards if they chose more challenging cost targets.

### Innovation Funding Initiative (IFI)

A mechanism to remunerate research & development expenditure by the transmission licensees.

## L

### Lattice Group Pension Scheme (LGPS)

A Retirement Benefit Scheme based upon benefits paid as a proportion of final salary or for newer members contributions paid to the scheme. The Scheme is an exempt approved scheme (ICTA'88) and is subject to a trust document. The Scheme is organised and defined by a set of rules, trustees and produces accounts annually and actuarial valuations at least every 3 years (triennially). The Pension Scheme is principally for people working in the Gas Utility Industries.

### Liquefied Natural Gas (LNG)

LNG consists mainly of methane gas liquefied at around -260 degrees Fahrenheit. Cooling and liquefying the gas reduces its volume by 600 times such that a tonne of LNG corresponds to about 1,400 cubic metres of methane in its gaseous state. LNG may be stored or transported by special tanker.

#### Load Related Capex

The installation of new assets to accommodate changes in the level or pattern of electricity or gas supply and demand.

### M

#### Monopolies and Mergers Commission (MMC)

The Competition Commission replaced the MMC on 1 April 1999. It is an independent public body. The CC conducts in-depth inquiries into mergers, markets and the regulation of the major regulated industries.

### N

#### National Grid Gas (NGG NTS)

The licensed gas transporter responsible for the gas transmission system, and four of the regional gas distribution companies.

#### National Transmission System (NTS)

The high pressure gas transmission system in Great Britain.

#### Non-Load Related Capex

The replacement or refurbishment of assets which are either at the end of their useful life due to their age or condition, or need to be replaced on safety or environmental grounds.

### O

#### One in Twenty Obligation

A licence obligation imposed by Standard Special Condition A9 (Pipe-Line System Security Standards) upon both NGG NTS and the GDNs.

#### Operating Expenditure (Opex)

The costs of the day to day operation of the network such as staff costs, repairs and maintenance expenditures, and overhead.

#### Operating Margin (OM)

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In relation to gas the OM is gas in storage which is reserved by the NTS to ensure the supply of gas is maintained in the event of a network emergency.

## **P**

### [Pipeline Maintenance Centre \(PMC\)](#)

Internal NG group providing specialised maintenance and emergency services for high pressure gas pipelines.

## **R**

### [Real Unit Operating Expenditure \(RUOE\)](#)

A measure of operating performance calculated by dividing the real operating expenditure in a year by an appropriate output measure.

### [Regulatory Asset Value \(RAV\)](#)

The value ascribed by Ofgem to the capital employed in the licensee's regulated transmission or (as the case may be) distribution business (the 'regulated asset base'). The RAV is calculated by summing an estimate of the initial market value of each licensee's regulated asset base at privatisation and all subsequent allowed additions to it at historical cost, and deducting annual depreciation amounts calculated in accordance with established regulatory methods. These vary between classes of licensee. A deduction is also made in certain cases to reflect the value realised from the disposal of assets comprised in the regulatory asset base. The RAV is indexed to RPI in order to allow for the effects of inflation on the licensee's capital stock. The revenues licensees are allowed to earn under their price controls include allowances for the regulatory depreciation and also for the return investors are estimated to require to provide the capital.

### [Repex](#)

In this consultation this term describes the use of an operating allowance to fund each year's expected non load related capital expenditure.

### [RPI-X](#)

The form of price control currently applied to network monopolies. Each company is given a revenue allowance in the first year of each control period. The price control then specifies that in each subsequent year the allowance will move by 'X' per cent in real terms.

### [Re-openers](#)

A process undertaken by Ofgem to re-set the revenue allowances (or the parameters that give rise to revenue allowances) under a price control before the scheduled next formal review date for the relevant price control.

#### Revenue Driver

A means of linking revenue allowances under a price control to specific measurable events which are considered to influence costs. Revenue drivers are used by Ofgem to increase the accuracy of the revenue allowances.

#### Rolling Incentives

A measure which ensures licensees are able to retain the rewards of efficiency savings for a period of five years (consistent with the duration of the price control) irrespective of when the efficiency saving is made.

### S

#### Sliding scale

This term is used generically to describe incentive schemes which involve profit (and loss) sharing around a fixed target costs, such as the current form of SO incentives in gas and electricity.

#### System Operator (SO)

The system operator has responsibility to construct, maintain and operate the NTS and associated equipment in an economic, efficient and co-ordinated manner. In its role as SO, NGG NTS is responsible for ensuring the day-to-day operation of the transmission system.

### T

#### Theoretical Maximum Physical Capacity

An approach to determining the level of baselines which can be characterised as the maximum amount of gas that can be taken through a particular entry or offtake point by reducing supplies at other nodes in order to balance the network but not taking into account interactions with flows elsewhere on the network.

#### Transmission Connected Customer (TCC)

A customer directly connected to the gas or electricity transmission system.

#### Transmission Owners (TO)

Companies which hold transmission owner licenses. Currently there are three electricity TOs; NGET, SPTL and SHETL. NGG NTS is the gas TO.

### Transmission Price Control Review (TPCR)

The TPCR will establish the price controls for the transmission licensees which will take effect in April 2007 for a 5-year period. The review applies to the three electricity transmission licensees, NGET, SPTL, SHETL and to the licensed gas transporter responsible for the gas transmission system, NGG NTS

## U

### Unit Cost Allowance (UCA)

A parameter of the current revenue restriction for NGG NTS. A UCA is set for each entry point, and is intended to reflect the cost of providing additional capacity at that point on the network. The actual additional revenue entitlement for NGG NTS if it releases such additional capacity at a particular entry point is a function of the UCA for that entry point. NGG NTS also uses the UCAs as reserve prices in its auctions of entry capacity.

### Uniform Network Code (UNC)

As of 1 May 2005, the UNC replaced NGG NTS's network code as the contractual framework for the NTS, GDNs and system users.

## V

### Vesting Assets

Assets included in the RAV at the vesting date.

### Vesting

The date at which the regulated gas and electricity transmission and distribution companies were privatised.

## Appendix 5 - 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:

1. Do you have any comments about the overall process, which was adopted for this consultation?
2. Do you have any comments about the overall tone and content of the report?
3. Was the report easy to read and understand, could it have been better written?
4. To what extent did the report's conclusions provide a balanced view?
5. To what extent did the report make reasoned recommendations for improvement?
6. Please add any further comments?

1.2. Please send your comments to:

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