

Joanna Whittington
Director - Gas Distribution
Office of Gas and Electricity Markets
9 Millbank

London
SW1P 3GE

Chris Bennett
Regulatory Frameworks Manager

chris.bennett@uk.ngrid.com
Direct tel +44 (0)1926 655949
Direct fax +44 (0)1926 656576

www.nationalgrid.com

26 January 2007

Dear Joanna,

National Grid UK Transmission's Response to Ofgem's third GDPCR Consultation

Thank you for the opportunity to respond to Ofgem's third consultation in the Gas Distribution Price Control Review. Our response covers three areas which are relevant to our UK Transmission business. These are:

- 1) Incentives;
- 2) Scottish Independent Undertakings;
- 3) Xoserve; and
- 4) Pensions.

Incentives

We focus our response to section 5 on the setting of capacity output incentives due to the effect that this may have on the amount of NTS exit capacity a GDN may book and the potential consequential impact on NTS investment.

We note that Ofgem has proposed 3 options to incentivise GDNs to purchase interruption and/or NTS exit capacity efficiently from April 2008;

- 1) sliding scale incentives for NTS flat capacity, NTS flex capacity and interruptions where GDNs are incentivised to make efficient trade offs between the capacity outputs until they reach either a cap or collar;
- 2) capex and opex allowances for each capacity output where GDNs are incentivised to make efficient tradeoffs between capacity outputs in accordance with capex and opex incentives; and
- 3) flexibility capacity incentive to seek to trade off NTS and LDZ flex products where GDNs incentivised to make efficient tradeoffs between the flexibility capacity outputs.

Without further details, we consider it difficult at this stage to fully understand the consequences of each option. We also recognise that it is difficult to fully develop such incentive arrangements with the current uncertainty in respect of the future NTS exit arrangements, in particular the degree of price uncertainty which may be associated with making long term NTS exit capacity commitments.

In principle, we consider that the use of sliding scale incentive arrangements may encourage GDNs to consider the most efficient and economic contracting strategy, while providing a degree of protection through appropriate setting of caps and collars from costs beyond its control. However we consider it important that such incentives are based on the actual costs of interruption on the distribution network and purchase of NTS Exit Capacity to prevent distortions in the NTS exit capacity market. The appropriate scope of incentive arrangements is to a large extent dependant on their detailed design.

We also note that an important feature of the incentive arrangements is whether it is based on long term NTS capacity bookings (as for the transitional incentive arrangements) or the total booked amount (i.e. including both day ahead and on the day capacity releases). We look forward to further details being provided in respect of how the proposed DN incentive arrangements will deal with this issue.

We consider below the two questions specific to capacity output measures.

Question 6. *Is flexibility capacity the key incentive to focus on for the capacity outputs? Should we assume that the use of existing NTS flex capacity is the most efficient flexibility capacity product?*

The design of the incentives associated with the flex capacity product is critical to avoiding distortions in the outcome of the annual flex capacity auctions. In the event that GDNs are able to pass on an inappropriate amount of the costs of purchasing flex capacity then this may result in GDNs being able to outbid shippers and hoard the available amount of flex capacity, limited to 22mcm. There is thus a risk that shippers are forced to increase their bid prices to compete with the GDNs resulting in significant revenue recovery through the flex auctions and adverse redistributive effects between exit users. However we also consider it important to ensure GDNs purchase NTS flat capacity efficiently.

Question 7. *Is it appropriate to assume that NTS and LTS flat capacity are complementary products? Should we incentivise tradeoffs between flat capacity and interruptible capacity?*

We agree that it is appropriate to assume that that NTS and LTS flat capacity are complementary products (ie. there is no opportunity for substitution between such products).

We consider that there is an ability to trade off flat capacity with LDZ interruption e.g. the greater the level of interruption, the less NTS flat capacity a GDN may need to purchase to ensure it could meet its 1 in 20 planning obligations. There would thus be benefits in setting a specific incentive to ensure an efficient trade-off between NTS flat capacity and LDZ interruption amounts as potentially "substitutable products".

Scottish Independent Undertakings

We believe that Ofgem should undertake a separate consultation process regarding any proposed changes to the relevant gas distribution and/or NTS licences in respect of the 'alternative arrangements'.

The alternative arrangements currently in place were agreed at the time of disposal of the Independent Distribution Networks as part of Hive Down and these alternative arrangements, which are prescribed in the legal undertakings, expire on 31st March 2008.

We understand that the Secretary of State has the power to determine suitable alternative arrangements Under paragraph 2A (a) of Standard Special Condition A27 (Disposal of Assets) of National Grid Gas's NTS licence. Standard Special Condition A27 (Disposal of Assets) is triggered **only** upon disposal of the transportation asset comprising an independent system and does not enable a revision of the current legal undertakings by the Secretary of State in any other circumstance. We therefore recommend that Ofgem undertakes a separate consultation process in this area.

Xoserve

In relation to the enduring arrangements for funding Xoserve's activities, we are strongly supportive of the ongoing industry dialogue and also supportive of the application of the 'user pays' principle where it promotes cost reflective charging and the efficient delivery of new or enhanced services. We respond to two specific questions below.

Question 1: *Do you agree with our assessment of the risks, costs and benefits attributable to the two options for the funding of xoserve?*

We agree with Ofgem's overall assessment that Option 2 is preferable to the status quo. However, we do not agree with Ofgem's positive assessment in the 'Responsiveness' criteria under core services plus user pays approach (Option 2) as it is currently expressed.

We do not believe that responsiveness will be enhanced under this approach because

- 1) The approach does not include a mechanism to recover the cost of necessary changes to core services conceived within the price control period and therefore provides a strong disincentive upon the Gas Transporters to support any necessary changes.
- 2) Developments may be delayed or halted altogether by disagreements over the correct allocation of costs. This risk could be mitigated by the development of pre-agreed cost allocation methodologies.

We recommend that changes to core services are funded through a mechanism for the recovery of incremental costs similar to that proposed by ourselves under the Transmission Price Control Review for NGG and NGET System Operator internal costs. Under this proposal, the costs of implementing desired changes would be discussed and weighed against the benefits under (in this case) the UNC

modification process with cost recovery triggered on adoption of the relevant modification. This would ensure that the incentives placed upon Gas Transporters to facilitate delivery of necessary changes were aligned with the industry's objectives.

Question 2: *If we adopt a core services plus user pays approach (Option 2), how should we define core services and user pays services?*

A range of definitions can be used for core services and user pays services around the broad philosophy of ensuring that benefiting parties bear the cost of services equitably within the practicalities of any cost allocation model. Our primary concern is that core services, and the mechanisms to manage them, are defined in a way that allows necessary changes conceived within the price control period to be funded.

Pensions

We believe that it would be entirely appropriate that, as Ofgem propose, the NTS charge for pension deficit costs relating to non-active scheme members should be given pass through treatment. These costs are regulated through the Transmission Price Control Review and thus it would be wholly inappropriate for these costs to have any other treatment.

I hope that these responses are helpful. If you wish to discuss these points further please contact me in the first instance on 01926 655949.

Yours sincerely

Chris Bennett
Regulatory Frameworks Manager