Promoting choice and value for all gas and electricity customers

National Grid Gas System Operator Incentives from 1 April 2007

Document type: **Final proposals and statutory licence consultation**

Ref: 43/07

Date of publication: 21 March 2007

Deadline for response: 18 April 2007

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

Overview:

National Grid Gas plc (NGG) is the system operator (SO) for the gas transportation system in Great Britain (GB). This document sets out our final proposals for an SO incentive scheme for NGG, including a statutory licence modification consultation. Provided that NGG consents to the licence modification, the changes will be effective retrospectively as of 1 April 2007. If NGG does not consent to the licence modification, we would need to decide whether to refer the matter to the Competition Commission or else to rely on direct regulation of NGG's SO costs based on our existing powers.

Contact name and details: Tim Dewhurst and Carlos Martinez
Tel: 020 7901 7000

Email: wholesale.markets@ofgem.gov.uk

Team: Wholesale Markets

Office of Gas and Electricity Markets, 9 Millbank, London, SW1P 3GE
www.ofgem.gov.uk

Context

This project is part of our overall work to regulate monopolies effectively. In both gas and electricity we consider it is important that the system operators are appropriately incentivised to operate their systems in an economic and efficient manner.

We believe that it is appropriate to develop incentives schemes that provide NGET and NGG with an appropriate balance of risk and reward which is in the interests of customers, who ultimately pay for the costs of system operation.

Associated Documents

- National Grid Electricity Transmission System Operator Incentives from 1 April 2007: Final proposals and statutory licence consultation: 27 February 2007
- National Grid Electricity Transmission and National Grid Gas System Operator Incentives from 1 April 2007: Initial proposals consultation: 5 December 2006
- National Grid Electricity Transmission and National Grid Gas System Operator Incentives from 1 April 2007: October consultation: 2 October 2006
- National Grid Electricity Transmission and National Grid Gas System Operator Incentives 2007-08 - Invitation to Submit Views: 5 July 2006

Table of Contents

Summary

In this document we set out our final proposals for the system operator (SO) incentive schemes for NGG to apply retrospectively from 1 April 2007. We have so far consulted three times on these schemes in the past financial year. [1]

Initial proposals

In December 2006, we published our initial proposals on the scope, form and duration of the gas SO incentive schemes to apply from 1 April 2007.

We proposed a rollover of the majority of parameters for the existing external gas SO incentives, for 2007/08. However, we did propose changes to the form of the gas shrinkage incentive (to vary the target on the basis of actual flows through the St Fergus NTS entry terminal), and a revision to the prices that apply to the system reserve incentive.

The majority of respondents considered it practical to retain the scope of the external incentives for this year. However, there was strong support for our commitment to review the external gas SO incentives more fundamentally ahead of April 2008.

With regards to the NGG NTS SO internal cost incentive we proposed a five year incentive (2007-12) to be consistent with the new NTS transmission price control review period. We also set out our proposed internal cost allowances for opex, capex, tax and pensions. The majority of respondents were supportive of our initial proposals for internal costs.

Our final proposals

Consistent with our initial proposals, we are proposing a one year incentive scheme for gas external costs, with a more fundamental review of these incentives before April 2008. The main areas of difference between the initial and final proposals have resulted from more information becoming available, particularly in relation to NGG's procurement of gas reserve and its performance under the quality of information incentive schemes.

We have updated our proposals for the gas reserve incentive to reflect actual bookings of Operating Margins (OM) made by NGG for 2007/08. This has led to a fall in the target cost of gas reserve in 2007/08 by around £0.6million.[2]

[1] In an open letter in July 2006, in our preliminary views in October 2006 and in our initial proposals document in December 2006.
[2] Calculated at current levels of regulated prices for gas reserve provided by LNG storage facilities.

We also note we will soon be publishing an open letter on proposed changes to the regulated prices at which NGG procures gas reserve from LNG facilities. We therefore propose explicitly including reference to these prices in the 2007/08 target for the cost of gas reserve.

We have also assessed the cost of gas reserve requirements at non-LNG storage facilities in 2007/08. We consider a value of £11million appropriate for inclusion in the gas reserve target for 2007/08 to meet this cost. However we will conduct a full and detailed review of these costs as part of our review of SO incentives later this year.

We have retained our initial proposal to base the 2007/08 target volume for gas shrinkage on actual flows through the St Fergus terminal. We have also retained the existing form of the residual balancing incentives.

We have revised the benchmarks for the quality of information incentives for 2007/08 to extend these from the current six month duration to a twelve month scheme. We have made the benchmarks for the demand forecasting and website timeliness incentives more challenging to reflect NGG's recent good performance over winter 2006/07. For website availability, we propose annualising the existing benchmark, and setting this on a quarterly basis (recognising that events that cause website downtime are typically low frequency and high impact in nature).

In light of respondents' views, we have decided not to proceed with the proposed incentive on NGG to limit emissions of methane from the NTS. However, we will consider the development of such an incentive in time for April 2008. This will allow us to understand interactions with existing environmental obligations on the gas SO in more detail.

Our final proposals for NGG's NTS SO internal costs are consistent with our initial proposals. As proposed in our October 2006 consultation, the internal cost incentive will allow NGG NTS SO to recover charges from xoserve which are being determined as part of the gas distribution price review (GDPCR).

Next steps

If NGG consents to our final proposals, these changes will be implemented retrospectively, effective from 1 April 2007. If the proposals are rejected, we would have to decide whether to refer the matter to the Competition Commission or else to rely on direct regulation of NGG's SO costs based on our existing powers.

In any event, we propose reviewing fundamentally the external gas SO incentives later this year. This review will lead to the proposal of revised incentives effective from April 2008.

1. Introduction

Chapter Summary

This chapter provides a short background of the process so far. It also provides an outline of the structure of this document and the way forward.

Question box

There are no specific questions in this chapter.

Background

1.1. In July 2006 we published an open letter inviting views on the historical performance of NGG as the gas SO, and on the scope and form of the gas SO incentive schemes to apply from 1 April 2007. This was followed in October 2006 by a preliminary views consultation (which also included background on the SO incentive schemes), and an initial proposals document published in December 2006.

1.2. We received thirteen responses (two of which were confidential) to our initial proposals consultation. A summary of these responses in respect of gas SO incentives can be found in Appendix 5.[3] Overall, respondents were supportive of the process that Ofgem is adopting for setting both the internal and external incentive schemes.

1.3. In addition to receiving respondents' views to our initial proposals, we have also received further information from NGG. All of this information has helped us to develop our final proposals for SO incentive schemes to apply to NGG's external and internal SO costs from 1 April 2007 which are discussed in this document.

Structure and approach

1.4. This final proposals document consists of three chapters. This chapter provides background, and outlines the process we are following in developing SO incentive schemes for NGG from 1 April 2007, the structure of the document and the way forward.

[3] The non-confidential responses are available in full on the Ofgem website www.ofgem.gov.uk.

1.5. In Chapter 2 we discuss our final proposals for SO incentive schemes to apply to NGG's external and internal SO costs from 1 April 2007. We explain how these final proposals have been developed since our initial proposals, and how we have reflected views of respondents to our previous consultation documents. In Chapter 3 we summarise briefly our next steps. Further details are provided in appendices in this document.

Way Forward

1.6. Appendix 6 of this document contains a statutory notice of our intention to modify by agreement NGG's gas transporter licence under section 23 of the Gas Act 1986. These modifications will implement the proposals set out in this document.

1.7. We would welcome the views of interested parties regarding all aspects of our proposed modifications. Responses should be sent to wholesale.markets@ofgem.gov.uk to be received no later than **18 April 2007**. Details of how to respond can be found in Appendix 1.[4]

1.8. The statutory notice under section 23 of the Gas Act 1986 specifies a period of not less than 28 days during which interested parties can make representations or objections to the proposed licence modifications, following which revisions to the proposed licence modifications will be made if they are considered appropriate. However, the modifications will not be made where the Secretary of State directs Ofgem not to make the modifications.

1.9. NGG must consent to the proposed licence modifications before they can be implemented. NGG has indicated to us its intention to consent to these modifications. If NGG does not consent to the proposed licence modifications Ofgem can refer the proposed SO incentive scheme modifications to the Competition Commission for final adjudication.

1.10. Alternatively, we could allow the incentive schemes to fall away. If this occurs, NGG will simply pass through its actual costs. Ofgem would then be responsible for directly regulating NGG's performance as SO and could take enforcement action and impose financial penalties if NGG was operating the gas system inefficiently or was found to be in breach of other relevant licence conditions.

1.11. If NGG consents, Ofgem intends, subject to any representations made during the consultation and any direction received from the Secretary of State, to direct the relevant modification of NGG's gas transporter licence in line with the

[4] Appendix 4 provides details of how to give feedback to us on the manner in which this consultation has been conducted.

proposed licence modifications shortly after 17 April 2007. These will be applied retrospectively, so that the new licence conditions will apply from **1 April 2007.**

2. Gas SO incentive schemes

Chapter Summary

This chapter outlines our final proposals for SO incentive schemes to apply to NGG's external and internal SO costs from 1 April 2007. We summarise respondents' views to our initial proposals consultation and present our final proposals for each component of the incentives schemes to apply from 1 April 2007.

Question box

Question 1: Do you consider that the final proposals for the SO incentive schemes to apply to NGG's external and internal SO costs represent a fair balance of risk and reward?

Question 2: Do you consider that the proposed licence modifications appropriately reflect the final proposals as described in this chapter?

2.1. This chapter outlines details of our final proposals for the gas SO incentives. These proposals are described in turn for:

- the external gas incentives, and
- the internal gas incentives.

External SO incentive scheme

2.2. This section outlines our final proposals for each of the components of the external gas SO incentives, namely:

- the gas shrinkage incentive;
- the system reserve incentive;
- the residual gas balancing incentive; and
- the quality of information incentives.

2.3. We also outline our final proposals for the treatment of income adjusting events.

Gas shrinkage incentive

2.4. There are three components to the gas shrinkage incentive, these are:

- the appropriate volume of gas shrinkage to use in the incentive target;
- the pricing of shrinkage gas; and
- the parameters (sharing factors, cap and collar) for this incentive.

Gas shrinkage volume

2.5. In our initial proposals consultation, we stated that gas shrinkage volumes were sensitive to flows on the network (and in particular to the extent to which gas enters the NTS through the St Fergus entry terminal). As NGG has no control over St Fergus throughput, in our initial proposals we **proposed setting the shrinkage volume target on the basis of the actual (outturn) level of flows through the St Fergus entry terminal**. We considered that this would mitigate the potential for windfall gains or losses to both customers and NGG resulting from unexpected volumes of flows through St Fergus. As such, we considered this proposal represented a more appropriate allocation of risk.

2.6. All respondents to our initial proposals considered it appropriate to vary the target for gas shrinkage based on the actual flows through St. Fergus.

2.7. We therefore propose no changes to our initial proposal. Our final proposal is therefore to specify three bands of flows through St Fergus, each of which will determine a different volume target. This is outlined in Table 2.1 below.

Table 2.1: Final Proposals for shrinkage volume targets for 2007/08

Average flows through St Fergus	**Volume target (GWh)**
High (over 100 mcm/day)	8,312
Medium (85mcm/day to 100mcm/day)	7,129
Low (below 85mcm/day)	6,393

2.8. In light of the forthcoming review of SO incentives, **we propose setting the duration of this incentive to apply only for 2007/08** (i.e. the incentive will fall away from April 2008). We consider this appropriate, as the target we propose in Table 2.1 is only intended to be relevant for one year.[5]

Gas shrinkage price

2.9. In our initial proposals consultation, we stated that the existing gas cost reference price (GCRP) methodology should be retained for the 2007/08 incentive period. We received some support for this proposal in response to our initial

[5] We propose doing this by amending NGG's NTS licence to state that the system balancing incentive revenue term (SBIRt) that comprises both gas cost and gas system reserve incentive revenue is only applicable for 2007/08 (i.e. for t=6).

proposals consultation. We would reiterate that this methodology will be assessed in the fundamental review of gas SO incentives we intend to undertake during this year.

2.10. Therefore, **our final proposal is that the existing GCRP methodology should be retained for 2007/08.**

Gas shrinkage incentive sharing factors, cap and collar

2.11. We suggested in our initial proposals (and October consultation document) that the sharing factors, cap and collar should remain unchanged (at 25%, £4 million upside and 20%, -£3 million downside). We received little comment on these proposals throughout our consultation process. We therefore continue to consider that maintaining these parameters provides an appropriate incentive for NGG to manage the costs associated with gas shrinkage for the 2007/08 incentive period.

2.12. **Our final proposal is therefore that the sharing factors, cap and collar for the gas shrinkage incentive should remain unchanged for 2007/08.**

System Reserve incentive

2.13. As with the gas shrinkage incentive, the gas reserve incentive target is also calculated on the basis of a volume projection and a pricing methodology. In the following sections we outline our final proposals for:

- the gas reserve target (including setting of volumes and reference prices); and
- the parameters (sharing factors, caps and collars) for this incentive.

Gas reserve target

2.14. Our views on final proposals for the volumes and prices to be used in the gas reserve target are set out below.

Volume

2.15. In our October consultation and initial proposals we set out our concerns that we considered (on the basis of a report by an external technical consultancy) that NGG's gas reserve requirements were overstated for 2007/08.

2.16. Respondents to our initial proposals consultation were supportive of a reduction in the gas reserve target for 2007/08. Respondents also encouraged Ofgem to undertake a further review of NGG's gas reserve volume requirements.

2.17. On the basis of respondents' views, we continue to consider there may be areas where NGG's forecasts include double provision of reserve as a result of overlap between different reserve requirements. However, we continue to believe that it would be most appropriate to address this issue when we undertake our fundamental review of the SO incentives before April 2008. This will enable us to address this issue in a more holistic fashion, taking into consideration potential interactions with gas safety monitors and proposed reform to the NTS offtake arrangements that will be undertaken this year.

2.18. Since publication of our initial proposals, NGG has finalised its booking of gas reserve (or Operating Margins (OM)) for 2007/08. These bookings are outlined by location in Table 2.2 below.

Table 2.2: Locational breakdown of gas system reserve requirements in 2007/08

Location	2007/08 gas reserve requirement (GWh)
Avonmouth LNG	213
Dynevor Arms LNG	116
Glenmavis LNG	135
Partington LNG	266
Other (non-LNG storage) locations[6]	764
Total	**1494**

2.19. These volumes differ from NGG's initial submission for gas reserve requirements (1,589GWh) and our initial proposals (1,550GWh). NGG has stated that the lower bookings are a consequence of a revision to its view of the supply / demand balance for 2007/08. **We therefore propose an aggregate volume of 1,494GWh as our final proposal for volumes of gas reserve in 2007/08**[7]**.**

Price

2.20. At present, the prices that the gas system operator pays for gas reserve bookings at the LNG storage facilities outlined in Table 2.2 are regulated by

[6] This category includes the Isle of Grain LNG importation facility (as this is no longer an LNG storage facility).
[7] At current levels of regulated prices for gas reserve services provided by LNG storage facilities, we calculate this represents a fall in the target cost of gas reserve in 2007/08 of around £0.55million.

Special Condition C3 of National Grid's NTS licence. This licence condition specifies prices of gas reserve bookings, set out by facility. This is necessary as these LNG storage facilities are owned by National Grid LNG Storage (a wholly owned subsidiary of National Grid).

2.21. We stated in our initial proposals consultation that the pricing arrangements for system reserve would be reviewed, with the potential for deviation away from using the existing price levels. Consistent with this, we will soon be publishing an open letter outlining in more detail proposed changes to Special Condition C3.

2.22. These changes are likely to include proposed revisions to the prices that will apply for 2007/08 for gas reserve booked at LNG storage facilities. We therefore propose expressing the target for this component of the gas reserve incentive as a function of the relevant Special Condition C3 prices. **Specifically, we propose multiplying each of the gas reserve volumes outlined in Table 2.2 by the appropriate reference price taken from Special Condition C3.**

2.23. In addition to gas reserve bookings at LNG storage facilities, NGG requires gas reserve elsewhere on the network. On the basis of a tender and negotiation, NGG has considered the most economic locations to be at the Rough, Hornsea and Hole House Farm storage facilities, as well as at the Isle of Grain gas importation facility in 2007/08. NGG has also stated that it is required to pay charges for the reprofiling of gas reserve bookings to 2007/08 levels, as well as charges associated with the expected utilisation of gas reserve.[8]

2.24. An area in which we have undertaken significant analysis since our initial proposals relates to the cost of booking gas reserve at the Isle of Grain facility. We asked NGG for evidence that the bookings at this facility were economic and efficient. As part of this analysis, we also investigated whether the agreement of the contract for the booking of gas reserve at the Isle of Grain was in any way influenced by the conversion of the Isle of Grain LNG storage facility into an LNG importation facility, the transfer of this facility to Grain LNG Limited (a wholly owned subsidiary of National Grid) and the subsequent sale of importation capacity to a third party.

2.25. NGG has stated that all of the bookings of gas reserve at this facility are locational, and that it does not consider there to be any substitutes for these bookings in 2007/08 (specifically pointing to the limited response NGG received to its tender for OM services for 2007/08). It has also provided analysis that

[8] Reprofiling costs are incurred when the level of bookings changes between years (leading to withdrawal (injection) costs when booked levels of gas reserve decrease (increase)). Utilisation of gas reserve incurs both withdrawal and injection charges as under Section K of the UNC, NGG is required to seek to maintain the same level of gas reserve over the gas year through the injection of additional gas to replace any that is utilised.

indicates that the price agreed by NGG for the provision of gas reserve at the Isle of Grain may be economic in 2007/08.

2.26. On this basis, we propose including £5.9m in the 2007/08 gas reserve cost target for the booking of gas reserve NGG has made at the Isle of Grain. However, we consider that a detailed assessment of the contract through which NGG has contracted for reserve at the Isle of Grain will form a necessary part of the review of SO incentives we will be undertaking later this year. For the avoidance of doubt, we therefore provide no assurance that any proportion of the cost of this contract will be allowed beyond 2007/08.

2.27. Our review will include a consideration of substitutes for gas reserve services provided by the Isle of Grain facility, as well as the interaction (and potential overlap) between volumes of gas reserve provided for OM and constrained LNG services. We will also be expecting NGG to provide significant analysis to support us in this review, focusing in particular on determining an economic and efficient level for bookings of gas reserve in the South East of England beyond April 2008.

2.28. In calculating the cost of bookings at the Isle of Grain, Rough, Hornsea and Hole House Farm, we have multiplied the booking requirement NGG has stated as being necessary at these locations by an estimate of an appropriate price for this reserve at each location (with reference to market determined prices where these are available).

2.29. We have calculated the total costs of gas reserve at locations other than LNG storage facilities to be £11million in 2007/08, comprising:

- £5.9m for bookings at the Isle of Grain LNG importation facility;
- £2.8m for bookings at the Rough gas storage facility;
- £1m for bookings at the Hornsea gas storage facility;
- £0.3m for bookings at the Hole House Farm gas storage facility; and
- £1m for reprofiling / utilisation costs.

2.30. We therefore propose including a further £11million in the target cost for gas reserve in 2007/08 to meet gas reserve costs other than those incurred from the booking of gas reserve at LNG storage facilities.

2.31. For the avoidance of doubt, the gas reserve incentive will form a key part of our review of SO incentives that we will conduct later this year (and conclude ahead of April 2008). This review will cover both the volume (and source) of gas reserve bookings NGG considers necessary for the safe operation of the network, the contestability and locational nature of some of these requirements and the price at which it is efficient for these bookings to be made.

2.32. In light of this review, we propose setting the duration of this incentive to apply only for 2007/08 (i.e. the incentive will fall away from April 2008). We consider this appropriate, as the target we have developed is only intended to be relevant for one year. [9]

Gas reserve parameters

2.33. The existing gas reserve incentive arrangements have 100% sharing factors, with no cap or collar on the incentive payment/receipt that NGG receives/faces. Historically, this approach has been adopted due to common ownership issues (given that NGG, as SO, procures a large proportion of its reserve services from the National Grid LNG facilities) and the current absence of contestability in the provision of system reserve services.

2.34. We note that NGG has outlined its intention to purchase reserve services from independent third party providers over the course of the next price control period (i.e. until April 2012) and we welcome developments in this respect. However, at present, there is not effective competition for these services. We therefore consider that it is appropriate to retain 100% sharing factors, with no cap or collar for the 12 month incentive period beginning 1 April 2007. We consider that this issue should be revisited in the context of our forthcoming review of NGG's external SO incentive arrangements to apply from 1 April 2008.

2.35. Therefore, **our final proposal is that the sharing factors, cap and collar for the system reserve incentive should remain unchanged.**

Residual gas balancing incentives

2.36. The residual gas balancing incentive is designed to give the SO a financial incentive to make balancing trades at an efficient price, and also limit significant changes in end-of-day linepack. This section presents our final proposals for these incentives.

Price incentive

2.37. We received no comments from respondents on our preliminary view or our initial proposal that the parameters of the existing price incentive should be rolled over for a further year. We continue to consider that this approach will provide appropriate incentives for NGG to manage the costs associated with its residual balancing actions for 2007/08. As previously outlined, we are committed to conducting a fundamental review of NGG's external SO incentive arrangements during 2007. This will allow any potential changes to the structure and

[9] As noted above, we propose doing this by amending NGG's NTS licence to state that the System balancing incentive revenue term (SBIRt) that comprises both gas cost and gas system reserve incentive revenue is only applicable for 2007/08 (i.e. for t=6).

parameters of this element of the residual balancing incentives to be thoroughly evaluated.

2.38. Therefore, **our final proposal is that the parameters for the price incentive should remain unchanged**.

Linepack incentive

2.39. Respondents to our initial proposals document stated they considered the scope and purpose of the linepack incentive should be reviewed. One respondent in particular questioned the value of this incentive.

2.40. We continue to consider it is appropriate to review this incentive, but that this is best undertaken as part of the more fundamental review that will take place during 2007. In light of this, we therefore believe that it is appropriate to retain the existing framework for 2007/08, in order to maintain consistent incentives for NGG in its role as residual balancer.

2.41. Therefore, **our final proposal is that the linepack incentive scheme parameters should remain unchanged for 2007/08**.

Quality of information incentives

2.42. The quality of information incentives, relating to both accuracy of day ahead gas demand forecasting and performance of NGG's website have been in place since 1 October 2006. These incentive arrangements were introduced as a direct result of proposals presented to (and developed by) the Demand Side Working Group.

Performance over winter 2006/07

2.43. Given the relatively short period of time over which these incentives have been in place, we have limited data on which to assess their effectiveness. At time of publication, we have received (and published) data on NGG's performance up to the end of January 2007[10].

2.44. This shows that NGG has performed well in terms of improvements in both the accuracy of gas demand forecasts and the timeliness of the posting of data on its website. However, due to a single event in December 2006, NGG has reached its collar on the website availability incentive.

---

[10] http://www.ofgem.gov.uk

Final proposals for quality of information incentives

2.45. Most respondents to our initial proposals stated that, if these incentives were retained for 2007/08, then incentive parameters should be revised to reflect NGG's recent performance. Respondents also supported reviewing the need for these incentives once more data on NGG's performance over winter 2006/07 is available.

2.46. Our final proposal is therefore to retain the quality of information incentives for 2007/08. We also consider it appropriate to include the quality of information incentives in the fundamental review of SO incentives that we will undertake prior to April 2008.

2.47. Consistent with our initial proposals, we propose maintaining the same monetary value for the caps, collars and target for 2007/08, but applying these for twelve months from April 2007 (i.e. effectively halving the monetary value of these incentives to NGG over the duration of the incentive). We consider this will maintain an effective incentive on NGG to continue to improve the accuracy of gas demand forecasting data and website performance over 2007/08. This also recognises that the original incentives were set on the basis of giving NGG an incentive to deliver immediate improvements to the quality of information delivered on its website in advance of winter 2006/07.

2.48. Our final proposals for the parameters of each of the information incentives are outlined in turn below.

Demand forecasting incentive

2.49. NGG's gas demand forecasting performance over the period October 2006 to January 2007 has been very good (compared to winter 2005/06). Specifically, the cumulative error from October 2006 to January 2007 has been 2.9% (significantly below the 'benchmark' demand forecasting error of 3.6% specified for winter 2006/07 as a whole).

2.50. To reflect this recent improvement in gas demand forecasting accuracy, we propose making the incentive benchmark more challenging for 2007/08. We therefore propose setting a revised benchmark at a level based on NGG's actual day ahead gas demand forecasting performance over 2006/07, adjusted downwards by a factor of 5%. This downward adjustment is the "target" performance improvement level specified in the existing incentive.

2.51. **Following this methodology means that our final proposal for NGG's gas demand forecasting incentive benchmark for 2007/08 is 4.0% of actual demand.**[11]

Website timeliness

2.52. NGG's website timeliness performance over winter 2006/07 to date has also been good. In all months since October 2006, NGG has comfortably exceeded the timeliness benchmark. For example, in January 2007 NGG posted data in the four monitored data fields in a timely fashion on over 99.5% of occasions. This compares to a benchmark level of 51.5%.

2.53. Given this strong performance, we believe the benchmark for 2007/08 needs to be tightened significantly. As such, **we propose revising the benchmark for the website timeliness from a requirement to post monitored data within 20 minutes on 51.5% of occasions to a requirement to post monitored data within 10 minutes on 75% of occasions.**

2.54. We consider that this proposal gives NGG a benchmark that better reflects recent performance levels. However, this also allows scope for further improvement in performance levels over 2007/08. [12]

Website availability

2.55. Over the period October 2006 to end of January 2007, cumulative downtime for the monitored fields on NGG's website was over 640 minutes. As the benchmark performance level for website availability is 362 minutes, this means that NGG has reached the "collar" for this part of the incentive. NGG will therefore not earn any incentive payments from website availability performance over winter 2006/07.

2.56. Although NGG's performance over winter 2006/07 with regard to website availability has not been good, the majority of "downtime" of the monitored fields on NGG's website resulted from a single incident in December 2006. This emphasised the "low frequency / high impact" nature of events that typically lead

[11] NGG's gas demand forecasting error over summer 2006 was calculated as being 4.89%. This includes an upwards adjustment of 0.79% to reflect unusually good forecasting accuracy resulting from increased certainty of offtake levels by the Rough storage facility. This compares to demand forecasting errors of 5.04% and 5.40% in Summer 2004 and Summer 2005 respectively.

[12] As a consequence of this change in benchmark (and the formula by which the website performance measure QWIPt is calculated), the maximum percentage improvement NGG can achieve in QWIPt in 2007/08 will be 66.7%. This has been reflected in the proposed licence changes presented in Appendix 6 of this document.

to website unavailability. It also illustrated that expressing the availability component of the website incentive as a single "downtime" benchmark means that a single event can lead to the collar of the incentive being reached for the entire duration of the incentive.

2.57. Despite NGG's actual downtime over winter 2006/07 being significantly higher than the existing benchmark, we do not consider it appropriate to give NGG a less challenging benchmark for 2007/08. The existing benchmark was subject to detailed consultation[13], and was based on actual website performance in winter 2005/06. **We therefore propose setting the benchmark level for the website availability incentive at 720 minutes (i.e. effectively annualising the existing benchmark).** [14]

2.58. However, recognising the potential sensitivity of this incentive to single events, **we also propose to apply the cap and collar of this element of the website incentive on a quarterly basis.** In effect this means that NGG will have an "allowance" of 180 minutes of website downtime in each quarter of 2007/08. Website performance will therefore be calculated on a quarterly basis, and performance in each quarter (as well any incentive payments that accrue as a result of good performance) will be measured independently of performance in other quarters.

Income Adjusting Events

2.59. Most respondents to the initial proposals consultation supported the continuation of Income Adjusting Event (IAE) provisions for external gas SO incentives. However, some expressed concern that a lack of transparency may make the assessment of proposed IAEs difficult.

2.60. We consider it essential that a consistent approach is taken towards IAE provisions in electricity and gas. **We therefore propose retaining the concept of IAEs for 2007/08.**

2.61. However, as made clear in our final proposals for NGET's 2007/08 system operator incentive scheme, we consider that IAEs should only be raised in the event of major structural changes in wholesale markets.[15]

2.62. As such, a condition of our final proposals is we would only expect NGG to raise IAEs in the event that there are unexpected and fundamental changes in

[13] For more details, see Potential new System Operator quality of information incentive schemes for National Grid Gas, Final proposals and statutory licence consultation, July 2006, Ofgem, 122/06.
[14] The current benchmark for availability is 362 minutes, which is approximately 60 minutes per month. Over a 12 month period, this is equivalent to a benchmark of 720 minutes.
[15] IAEs may also be needed in response to force majeure and/or security events.

wholesale energy markets in 2007/08. We also consider it important to note that, in developing our final proposals for external gas SO incentives, we have not identified any issues, areas of cost or potential events that we consider could constitute an automatic justification for an IAE at this time.

2.63. Finally, we also confirm our intent to review the IAE provisions more fundamentally as part of the wider review of NGG's SO scheme later this year.

Other issues

2.64. In our initial proposals consultation we also outlined the possibility of increasing the scope of the external SO incentives to include an incentive relating to methane emissions. Such an incentive would be designed to encourage the gas SO to limit methane emissions from the high pressure gas network.

2.65. There was little support from respondents to our initial proposal to introduce a methane emissions incentive scheme at this time. A key concern was that it was unclear how such an incentive would interact with existing environmental obligations on the gas SO. In addition, some respondents considered it would be difficult to measure NGG's performance and would be impractical to implement a scheme for just one year.

2.66. In light of respondents' views, we consider it more appropriate to develop this incentive in time for April 2008. This will also allow us to understand interactions with existing environmental obligations on the gas SO in more detail.

Internal SO incentive scheme

2.67. In our initial proposals document we set out our initial proposals for NGG's SO internal cost incentive for the period 2007 to 2012. Respondents were generally supportive of these proposals. Table 2.3 below sets out our final proposals.

2.68. Following further discussions with NGG we have made two adjustments since December. Firstly, we have removed identified pension costs from NGG's forecast of operating costs given that there is a separate allowance for pension costs. Secondly, we have adjusted our modelling of tax, in particular to ensure depreciation is calculated on a straight line basis. The combined effect of these two adjustments increases our total proposed allowances by £2.4 million.

Table 2.3 NGG Internal SO Costs 2007-2012 Final Proposals

(£ million, 2004/05 prices)	NGG Forecast	Ofgem Final Proposals	Change from Dec 2006
Opex	126.4	121.7	-0.4
Capex (Incentivised)	64.4	48.7	No change
Tax	n/a	6.2	+2.8
Pensions	n/a	34.4	no change

2.69. Our final proposals above will allow to NGG to recover on average £44.3 million per annum under the internal cost incentive. In addition NGG will also be allowed to recover charges relating to xoserve (discussed in more detail below).

2.70. As discussed in our initial proposals document, the allowances for pensions and tax are new for the SO internal incentive scheme and are consistent with our approach to NGG's transportation owner (TO) price control. These allowances will not be incentivised on an annual basis, instead, like the TO price controls these costs will be assessed for the whole of the five year period to 2012. New terms for pensions and tax have been introduced into NGG's gas transporter licence to allow it to recover these costs.

xoserve

2.71. xoserve provides commercial services to shippers and other industry participants on behalf of NGG NTS and the gas distribution networks (GDNs). The gas distribution price control review (GDPCR) is presently consulting on the funding model for xoserve and the level of xoserve costs the GDNs and NTS may recover through their price controls, this will be concluded in final proposals expected in December 2007.

2.72. In our preliminary views document we stated that an additional term would be introduced into NGG's SO internal cost incentive to allow it to recover charges from xoserve. We have used xoserve's forecast of charges to NGG to set the value for this term from 1 April 2007 at £6.6 million for 2007/08. It is important to note we have not assessed the efficiency of this forecast and no inference should be taken from this forecast regarding the GDPCR view on xoserve costs.

2.73. Following the GDPCR final proposals the value of the xoserve term in the SO internal incentive will be appropriately revised from 1 April 2008. Such revisions will also include any required adjustments of costs recovered in 2007/08. Accordingly, the values of the relevant proportion of charges levied on NGG by xoserve in respect of subsequent formula years have not currently been specified within the licence. However, it is expected that such values will be incorporated into the licence by way of future modifications to the relevant paragraph prior to 1 April 2008.

Incentives on capex and the roll forward of the RAV

2.74. In our initial proposals document we consulted on whether SO internal capital expenditure should be subject to a "fixed strength incentive" similar to that being introduced for the TO price control. The key features of the fixed strength incentive are:

- fixed sharing factors proposed at 25% upside and downside, to be applied each year to capital expenditure incurred which could then be added to the internal regulatory asset value (RAV); and
- notwithstanding the above, a disallowance of items from the RAV that are demonstrably wasteful or inefficient and an adjustment to claw back any revenue recovered on such expenditure.

2.75. Those respondents who commented were generally supportive of these proposals. Our final proposal is therefore to introduce a fixed strength incentive in the form outlined above (fixed sharing factors of 25% upside/downside). Operating costs will continue to be subject to the same sharing factors used in the external incentive. These changes are reflected in our proposed licence modification in Appendix 6. We would welcome respondents' views on whether the proposed licence modifications appropriately reflect these proposals.

NGG SO Internal costs associated with modifications to commercial frameworks

2.76. In our initial proposals document we consulted on how NGG should recover costs incurred as a result of modifications to commercial frameworks e.g. the Uniform Network Code (UNC) where these costs were clearly incremental to the baseline cost allowances. NGG proposed a mechanism that would allow the SO to recover such costs on an annual basis accompanied by greater transparency and accountability on NGG to report such costs to the industry. We also noted that such costs could be recovered through the existing income adjusting event (IAE) provision which has a threshold of £2 million for SO costs.

2.77. Respondents who commented on this issue were divided; some supported NGG's proposals whilst others expressed concerns, particularly regarding the transparency of such a process and the information made available regarding such costs. Having considered respondents' views, we propose that if such costs arise NGG should propose these as IAEs as we consider that the existing provisions have sufficient safeguards including a defined consultation process. To be consistent with the electricity SO internal incentive, we have amended the IAE threshold to be £1 million in respect of internal costs. This is reflected in our proposed licence modification in Appendix 6.

3. Way forward

Chapter summary

This chapter briefly summarises our next steps.

Question box

There are no specific questions in this chapter.

3.1. Responses to this consultation document should be sent to wholesale.markets@ofgem.gov.uk to be received no later than **18 April 2007**. Further details of how to respond can be found in Appendix 1.

3.2. The statutory notice under Section 23 of the Gas Act 1986 specifies a period of not less 28 days during which interested parties can make representations or objections to the proposed licence modification, following which revisions to the proposed licence modification will be made if they are considered appropriate. However, the Secretary of State may direct Ofgem not to make the modifications.

3.3. NGG must consent to the proposed licence modifications before they can be implemented. If NGG does not consent to the proposed licence modifications Ofgem can refer the proposed SO incentive scheme modifications to the Competition Commission for final adjudication. Alternatively, we could allow the incentive schemes to fall away. If this occurs, NGG will simply pass through its actual costs. Ofgem would then be responsible for directly regulating NGG's performance as SO and could take enforcement action and impose financial penalties if NGG was operating the system inefficiently or was found to be in breach of other relevant licence conditions.

3.4. If NGG consents, Ofgem intends, subject to any representations made during the consultation and any direction received from the Secretary of State, to direct the relevant modification of NGG’s gas transportation licence in line with the proposed licence modifications to apply retrospectively from 1 April 2007.

Appendices

Index

Appendix 1 – Consultation Response and Questions

1.1. We would welcome the views of interested parties regarding all aspects of our proposed modifications. Responses should be received by **18 April 2007** and should be sent to:

Sonia Brown
Director, Wholesale Markets
Ofgem
9 Millbank
LONDON
SW1P 3GE

1.2. Unless marked confidential, all responses will be published by placing them in Ofgem's library and on its website 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.

1.3. 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.

1.4. Any questions on this document should, in the first instance, be directed to Carlos Martinez-Rico (on 020 7901 7070), Email: wholesale.markets@ofgem.gov.uk.

Chapter One

There are no specific questions in this chapter.

Chapter Two

Question 1: Do you consider that the final proposals for the SO incentive schemes to apply to NGG's external and internal SO costs represent a fair balance of risk and reward?

Question 2: Do you consider that the proposed licence modifications appropriately reflect the final proposals as described in this chapter?

Chapter Three

There are no specific questions in this chapter.

Appendix 2 – 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.[16]

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[17].

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[18]; and
- The interests of individuals who are disabled or chronically sick, of pensionable age, with low incomes, or residing in rural areas.[19]

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:

[16] Entitled "Gas Supply" and "Electricity Supply" respectively.
[17] 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.
[18] 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.
[19] The Authority may have regard to other descriptions of consumers.

- Promote efficiency and economy on the part of those licensed[20] 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[21] 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.

[20] Or persons authorised by exemptions to carry on any activity.
[21] Council Regulation (EC) 1/2003

Appendix 3 – Glossary

D

Daily Metered (DM)

Supply points with meters which read volumes of gas consumed either on a continuous or on a daily basis.

Demand Side Working Group (DSWG)

Group set up by Ofgem intended to encourage demand side participation within the wholesale electricity market. The group considers, amongst other things, ways to remove barriers to entry to the market.

Downtime

The period over which a data field or page on NGG's website is not available.

G

Gas Day

The period from 06:00 hours on one day until 06:00 hours on the following day.

GDN

Gas Distribution Network

L

Linepack

The volume of gas within the National or Local Transmission System at any time.

Liquefied Natural Gas (LNG)

Gas stored and / or transported in liquid form.

Local Distribution Zones (LDZs)

LDZs are low pressure pipeline systems which deliver gas to final users and Independent Gas Transporters. There are twelve LDZs which take gas from the high pressure transmission system for onward distribution at lower pressures.

M

MCM

Millions of standard cubic metres.

N

NGET

National Grid Electricity Transmission plc (NGET) is the system operator (SO) for the electricity transmission system in Great Britain (GB), with responsibility for making sure that electricity supply and demand stay in balance and the system remains within safe technical and operating limits.

NGG

National Grid Gas plc (NGG) is the SO for the main gas transmission system in GB, by virtue of holding the gas transporter licence in respect of the National Transmission System.

NTS

The NTS (National Transmission System) is the high pressure gas network for the GB.

S

Sharing factors

These describe the percentage of profit or loss NGG will be subjected to if the relevant incentive performance measure falls below or exceeds the relevant incentive target.

Shippers

A person other than a Transporter who is for the time being bound by the UNC pursuant to a Shippers Framework Agreement.

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 is responsible for ensuring the day-to-day operation of the transmission system.

T

Therm

An imperial unit of energy largely replaced by the metric equivalent equal to 29.3071 kilowatt hours.

Transporter

National Grid NTS or a GDN.

U

Uniform Network Code (UNC)

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

Users

Under the UNC, a User is a person other than a Transporter who is bound by the Code pursuant to a Shippers Framework Agreement or a gas distribution network User.

Appendix 4 – 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:

Andrew MacFaul
Consultation Co-ordinator
Ofgem
9 Millbank
London
SW1P 3GE
andrew.macfaul@ofgem.gov.uk

Appendix 5 – Initial proposals consultation responses

1.1. To assist us in developing final proposals for the 2007/08 incentive schemes we published an initial proposals consultation document on 5 December 2006. This document presented our initial proposals for the SO incentive schemes to apply to NGET and NGG from 1 April 2007, and invited feedback from interested parties on these proposals.

1.2. We received thirteen responses to the initial proposals consultation document. The eleven non-confidential responses are published on Ofgem's website.[22] In addition to addressing the specific questions posed by Ofgem some parties chose to provide general comments. The views of respondents in relation to NGG's incentive scheme are outlined below. This section is intended to summarise the principal themes of respondents' views only and is not intended to provide a comprehensive overview of the responses received.

General comments

1.3. Two respondents made a general remark on the need for improved transparency in system operation processes and monitoring. One party considered that symmetrical caps and collars and narrower sharing factors should apply across the incentive scheme generally.

Comments on specific questions

Question 1: Do you agree with the proposed introduction of a new incentive to limit emissions of methane from the NTS from April 2007, and link this incentive to the prevailing price of carbon?

1.4. Respondents did not support the introduction of this incentive on the basis that it would be difficult to measure NGG's performance, impractical to implement for just one year, and as it tends to overlap the shrinkage incentive it could lead to a 'double benefit' for NGG. One party was in favour of introducing this incentive.

Question 2: Do you agree that the scope for all other components should remain the same as previous years for the external gas SO incentives?

1.5. Parties agreed that this was practical, however there was also strong support for the review Ofgem has committed to undertake ahead of setting incentives prior to April 2008.

[22] www.ofgem.gov.uk

Question 3: Do you agree with our proposal to vary the target for gas shrinkage on the basis of actual (2007/08) flows through St Fergus?

Question 4: Do you consider the proposed volumes for the shrinkage targets to be appropriate?

1.6. All respondents to the Initial Proposals consultation considered it appropriate to vary the target for gas shrinkage based on actual flows through St Fergus. Two parties were supportive of the targets proposed by Ofgem, while a further two were unclear exactly how these targets were determined.

Question 5: Do you consider it is appropriate to retain the existing gas reference price methodology for the gas shrinkage incentive?

1.7. There was tentative support among respondents for this proposal. A number agreed that the existing methodology should be retained for now, provided this is part of Ofgem's review of the SO scheme, while one party considered that the sharing factors should be the reverse of those proposed by Ofgem.

Question 6: Do you agree with our proposed target for gas reserve, and our intention to undertake a more fundamental review of this incentive in 2007?

Question 7: Do you agree with our proposal to review the reference prices that apply to the gas reserve incentive?

Question 8: Do you agree that, where market prices exceed reference prices for gas reserve, that the SO should pay these higher prices for OM gas?

1.8. Respondents were supportive of a reduction in the gas reserve target for 2007/08, a position formed largely on the basis of the increased shipper responsiveness argument, and encouraged a review of this target and the associated reference prices. Respondents tended to support Ofgem’s proposal that where market prices exceed these reference prices, NGG as SO should face these costs.

Question 9: Do you agree with our initial proposals to retain the existing form of the residual gas balancing incentives?

1.9. Respondents were supportive of Ofgem’s approach to the residual gas balancing incentives for 2007/08, on the condition these are also reviewed ahead of setting the scheme for 2008/09. One party noted that they remain un-supportive of the continuation of the linepack incentive based on its limited value.

Question 10: Do you have a view on the most appropriate form for the quality of information incentives in 2007/08? Do you consider these incentives should be revised in light of NGG's performance over winter 2007/08?

1.10. Respondents were generally sceptical, for various reasons, of the value of this incentive, and most considered that if it were to be continued, it should be tighter. A number of parties commented that there was not enough performance information available to undertake a proper assessment of this incentive.

Question 11: Do you agree with our views on IAEs going forward?

1.11. Ofgem’s position on the future of IAEs was generally supported by respondents, though a number of parties expressed concern about the transparency of the IAE process, and one party noted that it needs to be more clearly understandable.

Question 12: Do you agree with our Initial Proposals for internal costs?

Question 13: Do you agree that we should implement fixed sharing factors for internal capital expenditure? If so what should the level of the sharing factors be? Should the operating expenditure sharing factors be aligned with the capex factors, or aligned to the external incentive?

Question 14: Do you think incremental internal costs associated with modifications to commercial frameworks (e.g. UNC) should be accommodated through the existing IAE provisions or via a more automatic cost recovery process built around enhanced cost reporting and accountability to the industry through the existing commercial frameworks?

The internal SO cost proposals were agreed by all respondents, and there was some support for applying symmetric sharing factors to internal costs. As was the case with electricity, the respondents' views on the preferred method to remunerate the SO for costs incurred through implementing modifications, were mixed.

Appendix 6 – Notice under Section 23 of the Gas Act 1986

NOTICE OF MODIFICATION OF THE SPECIAL CONDITIONS OF NATIONAL GRID GAS PLC'S GAS TRANSPORTER LICENCE IN RESPECT OF ITS NATIONAL TRANSMISSION SYSTEM UNDER SECTION 23 OF THE GAS ACT 1986

1. National Grid Gas plc ("NGG") holds a gas transporter licence (the "licence") in respect of its National Transmission System ("NTS") treated as granted pursuant to section 7 of the Gas Act 1986 (the "Act").

2. In accordance with section 23(3) and (4) of the Act, the Gas and Electricity Markets Authority (the "Authority") gives notice that it proposes to modify the special conditions of the licence in accordance with the Schedule to this Notice.

3. The proposed licence modifications are intended to implement proposals relating to the NTS system operation activity incentive scheme from 1 April 2007. In summary, the effects of the proposed licence modifications are:

   (a) to revise the target for the gas system reserve incentive to make this appropriate for the year 1 April 2007 to 1 April 2008, and also to refer explicitly to reference prices as set out in Special Condition C3 for the pricing of reserve held at LNG storage facilities;

   (b) to enable the target for gas shrinkage to be varied according to the actual flows through the St Fergus NTS entry terminal for the year 1 April 2007 to 1 April 2008;

   (c) to revise targets for quality of information incentives to make these appropriate for the year 1 April 2007 to 1 April 2008;

   (d) to amend the availability component of the website information incentive, so as to make this apply on a quarterly basis for the year 1 April 2007 to 1 April 2008; and

   (e) to set the new internal cost incentive for the period 1 April 2007 to 1 April 2012.

4. Subject to the outcome of this statutory consultation, consideration of respondents' views and the consent of NGG being given, it is the intention of the Authority that these proposed licence modifications shall have effect on and from 06:00 hours on 1 April 2007.

5. The reasons why the Authority proposes to make these licence modifications were published by the Authority in the following documents:

   (a) "National Grid Gas System Operator Incentives from 1 April 2007: Final proposals and statutory licence consultation", Ofgem, March 2007;

(b) "National Grid Electricity Transmission and National Grid Gas System Operator Incentives from 1 April 2007: Initial proposals consultation", Ofgem, December 2006;

(c) "National Grid Electricity Transmission and National Grid Gas System Operator Incentives from 1 April 2007: October consultation", Ofgem, October 2006;

(d) "National Grid Electricity Transmission and National Grid Gas System Operator Incentives 2007-08 – Invitation to submit views", Ofgem, July 2006.

These documents are available free of charge from the Ofgem Research and Information Centre, 9 Millbank, London SW1P 3GE or from the Ofgem website at www.ofgem.gov.uk.

6. Any representations or objections to the proposed licence modifications may be made before 18 April 2007 and sent to:

Sonia Brown
Director, Wholesale Markets
Ofgem
9 Millbank
London SW1P 3GE

or by e-mail to wholesale.markets@ofgem.gov.uk.

Sonia Brown
Director, Wholesale Markets
Duly authorised on behalf of the Gas and Electricity Markets Authority

21 March 2007

SCHEDULE

PROPOSED MODIFICATION OF THE SPECIAL CONDITIONS OF NATIONAL GRID GAS PLC'S GAS TRANSPORTER LICENCE IN RESPECT OF ITS NATIONAL TRANSMISSION SYSTEM UNDER SECTION 23 OF THE GAS ACT 1986

1. Special condition C8B (Restriction of revenue in respect of the NTS transportation owner activity and NTS system operation activity), Part 2 (The NTS system operation activity revenue restrictions) is amended as follows.

2. In paragraph 14(2) (NTS system operator incentive revenue ($SOIR_t$)):

   (a) for "$ICIR_t$", where it appears, substitute "$SOIntlCR_t$";

   (b) for "the last 6 months of formula year t=5 (i.e. 1 October 2006 to 1 April 2007)", substitute "formula year t=6".

3. In paragraph 14(3) (NTS system operation costs) ($SOIC_t$)):

   (a) in the formula from which $SOIC_t$ is derived, "+ $ICCP_t$ " is omitted;

   (b) the definition of $ICCP_t$ is omitted.

4. In paragraph 14(8) (System balancing incentive revenue ($SBIR_t$)):

   (a) in sub-paragraph (a), for "formula year t" where it appears, substitute "formula year t=6";

   (b) in sub-paragraph (c) (The maximum system reserve incentive revenue $(SRIR_t)$), for the definition of "$SRIT_t$", substitute:

"$SRIT_t$ means the system reserve incentive target in respect of formula year t (in £m), which shall be derived in the following manner:

$$SRIT_t = ((RPAV_t \times 213) + (RPDY_t \times 116) + (RPGL_t \times 135) + (RPPA_t \times 266)) / 100 + 11$$

where:

$RPAV_t$ means the applicable price for reserved space, in formula year t (in pence per kWh per annum), with respect to the Avonmouth LNG storage facility, as determined by Special Condition C3;

$RPDY_t$ means the applicable price for reserved space, in formula year t (in pence per kWh per annum), with respect to the Dynevor Arms LNG storage facility, as determined by Special Condition C3;

$RPGL_t$ means the applicable price for reserved space, in formula year t (in pence per kWh per annum), with respect to the Glenmavis LNG storage facility, as determined by Special Condition C3;

$RPPA_t$ means the applicable price for reserved space, in formula year t (in pence per kWh per annum), with respect to the Partington LNG storage facility, as determined by Special Condition C3;";

(c) in sub-paragraph (d) (The NTS SO gas cost incentive target $(GCIT_t)$), for the definition of "$GVTP_t$" substitute:

"$GVTP_t$ means the NTS SO gas target volumes in respect of formula year t, as set out in the table below. The value of $GVTP_t$ is dependant upon the level of $SFAF_t$, where $SFAF_t$ means the average daily gas flows through the St. Fergus terminal in mcm/day in the formula year commencing on 1 April 2007, calculated as:

$$\frac{(\text{Total annual volumetric flow through St Fergus terminal})}{366}$$

$SFAF_t$ (mcm/day)	**$GVTP_t$ (GWh)**
$SFAF_t > 100$	8,312
$85 \le SFAF_t \le 100$	7,129
$SFAF_t < 85$	6,393"

5. For paragraph 14(10) (Internal cost incentive)), substitute:

"**(10) Internal cost incentive revenue ($SOIntICR_t$)**

(a) Principal formula

For the purposes of paragraph 14(2) of Part 2 of this condition, the maximum internal costs incentive revenue allowed to the licensee in respect of formula year t ($SOIntICR_t$) shall be derived in the following manner:

$$SOIntICR_t = IOIRC_t + ICEIRC_t + NC_t$$

Where:

$IOIRC_t$ means the maximum internal operating cost incentive revenue allowed in respect of formula year t and shall be calculated in accordance with paragraph 14(10)(b) of Part 2 of this condition;

$ICEIRC_t$ means the maximum internal capital expenditure incentive revenue allowed in respect of formula year t and shall be calculated in accordance with paragraph 14(10)(c) of Part 2 of this condition;

NC_t means the non incentivised costs allowed in respect of formula year t and shall be determined in accordance with paragraph 14(10)(d) of Part 2 of this condition.

(b) Internal operating cost incentive revenue ($IOIRC_t$)

For the purposes of paragraph 14(10)(a) of Part 2 of this condition, the maximum internal operating costs incentive revenue allowed to the licensee in respect of formula year t ($IOIRC_t$) shall be derived in the following manner:

If $\left[1+\left(\frac{IRPI_t}{100}\right)\right]\times IOIT_t \geq IOC_t$, then:

$$IOIRC_t = \left(\left[1+\left(\frac{IRPI_t}{100}\right)\right]\times IOIT_t\right) - \left(\left(\left(\left[1+\left(\frac{IRPI_t}{100}\right)\right]\times IOIT_t\right) - IOC_t\right)\times\left(1-ICUSF_t\right)\right)$$

otherwise:

$$IOIRC_t = \left(\left[1+\left(\frac{IRPI_t}{100}\right)\right]\times IOIT_t\right) - \left(\left(\left(\left[1+\left(\frac{IRPI_t}{100}\right)\right]\times IOIT_t\right) - IOC_t\right)\times\left(1-ICDSF_t\right)\right)$$

where:

$IOIT_t$ means the internal cost incentive target in respect of formula year t as set out in the following table:

	Formula years

Variable	t=6	t=7	t=8	t=9	t=10
$IOIT_t$ £ million, 04/05 prices	24.2	23.2	25.4	24.6	24.2

IOC_t means the operating costs incurred in respect of formula year t attributable to the provision of NTS SO activity in accordance with Special Condition C9 (Allocation of revenues and costs for calculations under the price control in respect of the NTS transportation owner activity and NTS system operation activity) other than $ExCP_t$, $IECCC_t$, $CNIC_t$, $SBIC_t$, $RBIC_t$,Pension Costs and charges levied on the licensee by the agency (as defined in Standard Special Condition A15);

Pension Costs means the actual cash contributions made to the scheme in respect of both ongoing contributions and deficit payments attributable to the transportation system as well as scheme administration costs and payments made to the Pension Protection Fund (as defined under the Pensions Act 2004);

$ICUSF_t$ means the internal cost upside sharing factor in respect of formula year t as set out in the following table:

	Formula years				
Variable	**t=6**	**t=7**	**t=8**	**t=9**	**t=10**
$ICUSF_t$	0.4	0.4	0.4	0.4	0.4

$ICDSF_t$ means the internal cost downside sharing factor in respect of formula year t as set out in the following table:

	Formula years				
Variable	**t=6**	**t=7**	**t=8**	**t=9**	**t=10**
$ICDSF_t$	0.4	0.4	0.4	0.4	0.4

$IRPI_t$ in respect of formula year t, means the percentage change (whether of a positive or a negative value) between (a) the arithmetic average of the retail price index published or determined with respect to each of the six months from July to December (both inclusive) in formula year t-1 and (b) 182.37 (being the value for t-1 in 2004/05).

(c) Internal capital expenditure incentive revenue ($ICEIRC_t$)

For the purposes of paragraph 14(10)(a) of Part 2 of this condition, the maximum internal capital expenditure incentive revenue allowed to the licensee in respect of formula year t ($ICEIRC_t$) shall be derived in the following manner:

$$ICEIRC_t = ICED_t + ICER_t$$

where:

$ICED_t$ means the depreciation on the NTS SO regulatory asset base in respect of formula year t and is calculated on a straight-line basis using a life of seven years for assets;

$ICER_t$ means the return on the average NTS SO regulatory asset value in respect of formula year t at a rate of 5.05%;

"NTS SO regulatory asset value" means the allocation of assets to the NTS SO activity in accordance with Special Condition C9 (Allocation of revenues and costs for calculations under the price control in respect of the NTS transportation owner activity and NTS system operation activity); and has the value £40.3m (in 2004/05 prices) on 1 April 2007. Allowed internal capital expenditure ($AICE_t$) shall be added to the NTS SO regulatory asset value in respect of any relevant year t;

$AICE_t$ means the allowed internal capital expenditure that shall be added to the NTS SO regulatory asset base in respect of any formula year t and is derived in the following manner:

$$AICE_t = \left(\left[1 + \left(\frac{IRPI_t}{100} \right) \right] \times ICET_t \right) - \left(\left(\left(\left[1 + \left(\frac{IRPI_t}{100} \right) \right] \times ICET_t \right) - ICE_t \right) \times 0.75 \right)$$

where:

$ICET_t$ means the internal capital expenditure target in respect of formula year t as set out in the following table:

	Formula years				
Variable	**t=6**	**t=7**	**t=8**	**t=9**	**t=10**
$ICET_t$ £ million, 04/05 prices	12.8	8.3	6.5	10.8	10.3

ICE_t means the internal capital expenditure allocated to the NTS SO activity in accordance with Special Condition C9 (Allocation of revenues and costs for calculations under the price control in respect of the NTS transportation owner activity and NTS system operation activity) in respect of formula year t.

(d) Non-incentivised costs (NC_t)

For the purposes of paragraph 14(10)(a) of Part 2 of this condition, the non-incentivised costs allowed to the licensee in respect of formula year t (NC_t) shall be derived in the following manner:

$$NC_t = (IT_t + IP_t + IX_t) \times \left[1 + \left(\frac{IRPI_t}{100}\right)\right]$$

where:

IT_t means the licensee's tax allowance in respect of its NTS system operation activity in respect of formula year t as set out in the following table:

	Formula years				
Variable	**t=6**	**t=7**	**t=8**	**t=9**	**t=10**
IT_t, (£ million, 04/05 prices)	3.1	2.1	1.3	0.0	-0.4

IP_t means the licensee's pension cost allowance in respect of its NTS system operation activity in respect of formula year t as set out in the following table:

	Formula years				
Variable	**t=6**	**t=7**	**t=8**	**t=9**	**t=10**
IP_t, (£ million, 04/05 prices)	6.7	6.9	6.8	7.1	7.1

IX_t means the relevant proportion (in respect of its NTS system operation activity) of the charge levied on the licensee by the agency (as defined in Standard Special Condition A15) in respect of formula year t as set out in the following table:

	Formula years				
Variable	**t=6**	**t=7**	**t=8**	**t=9**	**t=10**
$IX_{t,}$ (£ million, 04/05 prices)	6.6				

$IRPI_t$ has the same meaning ascribed to it in paragraph 14(10)(b) of Part 2 of this condition."

6. In paragraph 14(11) (Determination of any adjustment factor to be applied to $SOMR_t$ ($SORA_t$)):

(a) in sub-paragraph (a)(iv) for the paragraph beginning with the words "where the event has" substitute:

"where the event has, for relevant formula year t:

(aa) increased or decreased the value of $SOIC_t$ (having the meaning given to that term in paragraph 14(3) of Part 2 of this condition) by more than £2,000,000 (the "threshold amount"). This threshold amount does not apply in respect of sub-paragraphs 14(11)(a)(ii) or 14(11)(a)(iii); or

(bb) increased or decreased the value of IOC_t (having the meaning given to that term in paragraph 14(10)(b) of Part 2 of this condition) or ICE_t (having the meaning given to that term in paragraph 14(10)(c) of Part 2 of this condition) by more than £1,000,000 (the "internal threshold amount") and is demonstrably not included in $IOIT_t$ or $ICET_t$ respectively for formula year t. This internal threshold amount does not apply in respect of sub-paragraphs 14(11)(a)(ii) or 14(11)(a)(iii) above.";

(b) in subparagraph (i)(ii):

(i) after "threshold amount," where it first appears, insert, " or IOC_t or ICE_t by more than the internal threshold amount,";

(ii) after "threshold amount" where it next appears, insert "and internal threshold amount".

7. In paragraph 14(13) (Quality of information incentive):

(a) in sub-paragraph (a) (principal formula), for Table (B) substitute:

$QWIP_t$	$QWIIR_t$
$QWIP_t \leq 0$	0
$0 < QWIP_t < 0.27$	($QWIP_t$ x 100) x £0.037m
$QWIP_t = 0.27$	£1m
$0.27 < QWIP_t < 0.67$	[(($QWIP_t$ – 0.27) x 100)x £0.01261m] + £1m
$QWIP_t \geq 0.67$	£1.5m

(b) in sub-paragraph (b) (Quality of demand information performance measure):

(i) for the first formula (from which $QDIP_t$ is derived), substitute:

$$QDIP_t = \frac{\left(0.040 - \dfrac{\sum_{d}^{D} \left| DADF_d - AD_d \right|}{\sum_{d}^{D} AD_d}\right)}{0.040}$$

(ii) for,

"Where d is the first day of the scheme, commencing at 06:00 on the 1st October 2006, and D is the final day of the scheme, finishing at 06:00 on 1st April 2007",

substitute:

"Where d is the first day of formula year t, and D is the final day of formula year t";

(iii) for the definition of "$DADF_d$" substitute:

"$DADF_d$ means the day-ahead forecast NTS throughput value (in mcm) published by the licensee (in accordance with the Network Code) on its website not later than 14:00 hours at day ahead (d-1) in respect of each day of formula year t. Where the day ahead 14:00 forecast NTS throughput value is not published by 14:00 hours at day ahead (d-1), the next forecast published on the licensee's website for the gas day concerned shall be used";

(iv) for the definition of "AD_d", substitute:

"AD_d means Actual NTS Throughput (in mcm) on a given day (d), calculated five days following the day (d+5), on each day of formula year t";

(v) for the definition of "Actual NTS Throughput" substitute;

"Actual NTS Throughput means the total offtake of gas from the NTS on each day (measured in mcm), including gas offtakes by DN Operators, Storage Facilities, interconnectors and Very Large Daily Metered Consumers (VLDMC) connected to the NTS, plus the physical elements of NTS Shrinkage;

and:

DN Operators, Shrinkage, Storage Facilities and VLDMC have the meaning given to those terms in the Network Code.";

(c) for sub-paragraph (c) (Quality of website information performance measure) substitute:

"(c) Quality of website information performance measure

For the purposes of paragraph 14(13)(a) of Part 2 of this condition the quality of website information performance measure (QWIPt) shall be derived from the following formula:

$$QWIP_t = \frac{\left\{ \sum_{eachquarterq\,\mathrm{int}} \frac{\left\{ MAX\left[\left(\frac{180 - WPM_q}{180}\right), 0\right]\right\}}{4} + MAX\left[\left(\frac{WTP_t - 0.75}{0.75}\right), 0\right] \right\}}{2}$$

where,

WPM_q means website availability performance measure, calculated as follows:

$$WPM_q = \frac{(WAPL_q + WAPNN_q + WAPNA_q + WAPDF_q)}{4},$$

"q" means each quarter year;

"quarter year" means the first, second, third and fourth three calendar months of formula year t;

"calendar month" has the meaning given to that term in the Network Code;

and,

WTP_t means the website timeliness performance measure calculated as follows:

$$WTP_t = \frac{(WTPL_t + WTPNN_t + WTPNA_t + WTPDF_t)}{4}$$

where,

$WAPL_q$ means the website availability performance measure for the licensee's Predicted Closing Linepack Data Item or Report expressed as the number of minutes of downtime of the Predicted Closing Linepack Report published on the licensee's website in each quarter year;

$WAPNN_q$ means the website availability performance measure for the licensee's National Forecast Flow Data Item or Report expressed as the number of minutes of downtime of the National Forecast Flow Report published on the licensee's website in each quarter year;

$WAPNA_q$ means the website availability performance measure for the licensee's National Physical Flow Data Item or Report expressed as the number of minutes of downtime of the National Physical Flow Report published on the licensee's website in each quarter year;

$WAPDF_q$ means the website availability performance measure for the licensee's NTS Throughput Data Item or Report expressed as the number of minutes of downtime of the NTS Throughput Report published on the licensee's website in each quarter year;

$WTPL_t$ means the website timeliness performance measure for the licensee's Predicted Closing Linepack Data Item or Report, and has a value between 0 and 1, representing the proportion of occasions during formula year t that hourly data updates were posted within 10 minutes of the start of the hour (i.e. the 12:00 update published by 12:10 at the latest), expressed as a proportion of all publication occasions;

$WTPNN_t$ means the website timeliness performance measure for the licensee's National Forecast Flow Data Item or Report, and has a value between 0 and 1, representing the proportion of occasions during formula year t that hourly data updates were posted within 10 minutes of the start of the hour (i.e. the 12:00 update published by 12:10 at the latest), expressed as a proportion of all publication occasions;

$WTPNA_t$ means the website timeliness performance measure for the licensee's National Physical Flow Data Item or Report, and has a value between 0 and 1, representing the proportion of occasions during formula year t that hourly data updates were posted within 10 minutes of the start of the hour (i.e. the 12:00 update published by 12:10 at the latest), expressed as a proportion of all publication occasions;

$WTPDF_t$ means the website timeliness performance measure for the licensee's NTS Throughput Data Item or Report, and has a value between 0 and 1, representing the proportion of occasions during formula year t that the 14:00 hours (day ahead), 02:00 hours (day ahead), 12:00 hours (within day), 15:00 hours (within day), 18:00 hours (within day) and 21:30 (within day) publication deadlines are met;

NTS Throughput Data Item or Report means a data item or report published by the licensee showing, amongst other data, the forecast level of Actual NTS Throughput;

Predicted Closing Linepack Data Item or Report means an hourly data item or report published by the licensee showing, for each day, the opening NTS Linepack, two projected closing NTS Linepack figures, and Forecast Total System Demand (measured in mcm). NTS Linepack and Forecast Total System Demand have the meaning given to those terms in the Network Code;

National Forecast Flow Data Item or Report means an hourly data item or report published by the licensee showing, for each day, aggregate forecast flows of gas into the NTS based on delivery flow nominations (measured in mcm);

National Physical Flow Data Item or Report means an hourly data item or report published by the licensee showing, for each day, aggregate forecast flows of gas into the NTS based on actual (aggregate) physical flows into the NTS (measured in mcm).";

(d) in sub-paragraph (d)(i) (Exceptional events), for "the last 6 months of formula year t=5 (i.e. 1st October 2006 to 1 April 2007)", substitute "formula year t".

8. In paragraph 16(5) (Disapplication of the NTS SO activity revenue restriction):

(a) sub-paragraph (ii)(ee) is omitted;

(b) in sub-paragraph (iii), for “31 March 2007” substitute “1 April 2008”.