

Section 38A notice in respect of reasons for the decision to modify the licence of National Grid Gas plc

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Target Audience: National Grid Gas NTS, gas shippers, entry terminal operators and other interested parties

Overview:

This document sets out the reasons for the decision to modify special conditions of National Grid Gas plc's (NGG) gas transporter licence in respect of the National Transmission System (NTS) as required under section 38A of the Gas Act 1986.

We have made the decision to modify NGG NTS's licence in order to give full effect to our Final Proposals for the Transmission Price Control Review (TPCR) for NGG NTS.

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Context

Ofgem's Final Proposals for the Transmission Price Control Review (TPCR) were issued in December 2006. We subsequently decided that it would be desirable to implement these proposals in two stages, the first stage to bring forward the proposed licence modifications deemed necessary to ensure that the commercial framework from 1 April 2007 is aligned with the new proposals and the second stage to introduce the remainder of the proposed licence modifications.

This document sets out the reasons for Ofgem's decision to modify the gas transporter licence of National Grid Gas plc (NGG) in respect of the National Transmission System (NTS). This decision completes the second stage of the process of implementation set out above.

Associated Documents

- Ofgem (July 2005), Transmission price control review: Initial consultation (Ref. No. 172/05)
- Ofgem (December 2005), Transmission price control review: Second consultation (Ref. No. 277/05)
- Ofgem (30 March 2006), Transmission Price Control Review 2007 - 2012: Third Consultation (Ref. No. 51/06)
- Ofgem (26 June 2006), Transmission Price Control Review: Initial Proposals (Ref. No. 104/06)
- Ofgem (12 July 2006), Incentive arrangements for the provision of NTS entry capacity at Milford Haven, Decision Document (Ref. No. 118/06)
- Ofgem (25 September 2006), Transmission Price Control Review: Updated Proposals (Ref. No. 170/06)
- Ofgem (15 November 2006), Transmission Price Control Review: Draft licence modifications (Ref. No. 197/06)
- Ofgem (4 December 2006), Transmission Price Control Review: Final Proposals (Ref. No. 206/06)
- Ofgem (5 December 2006), National Grid Electricity Transmission and National Grid Gas System Operator Incentives from 1 April 2007, Initial proposals consultation (Ref. No. 208/06)
- Ofgem (26 January 2007), Transmission price control review: Draft licence conditions (gas) second informal consultation (Ref. No. 16/07)
- Ofgem (16 February 2007), Notice under section 23 (3) of the Gas Act 1986 (Ref. No. 27/07)
- Ofgem (21 March 2007), National Grid Gas System Operator Incentives from 1 April 2007, Final proposals and statutory licence consultation (Ref. No. 43/07)
- Ofgem (30 March 2007), Modification of the gas transporter licence under section 23 of the Gas Act 1986 (Ref. No. 61/07)
- Ofgem (30 March 2007), Section 38A notice in respect of reasons for the decision to modify the licence of National Grid Gas plc (Ref. No. 61/07)

- Ofgem (19 April 2007), 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 (Ref. No. 89/07)
- Ofgem (19 June 2007), National Grid Gas National Transmission System Entry Capacity: Development of the regime ahead of winter 2007/08 (Ref. No. 148/07)
- Ofgem (25 June 2007), Notice under section 23 (3) of the Gas Act 1986 (Ref. No. 151/07)
- Ofgem (27 June 2007), National Grid Gas National Transmission System System Entry Capacity: Development of the regime in the medium and longer term (capacity substitution) (Ref. No. 157/07)
- Ofgem (27 July 2007), Further consultation on NTS entry capacity baselines (Ref. No. 192/07)
- Ofgem (30 July 2007), Notice under section 23 (3) of the Gas Act 1986 (Ref. No. 195/07)
- Ofgem (3 August 2007), LNG Storage price control – Initial thoughts, Consultation (Ref. No. 202/07)

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Summary

Transmission Price Control Review (TPCR)

For over two years we have been in the process of reviewing and implementing the price control of National Grid Gas (NGG) in respect of its National Transmission System (NTS). The price control determines how much revenue NGG NTS is permitted to recover and sets out what NGG NTS is expected to deliver in exchange for this revenue allowance. This is an important process that ensures the continued and effective regulation of network monopolies, in order to protect the interests of consumers.

The process of reviewing the price control of NGG NTS (and other transmission licensees) concluded with the publication of our Final Proposals in December 2006.

Implementation of TPCR

In order to give effect to our Final Proposals, we need to modify NGG's gas transporter licence in respect of the NTS. It is important that the revised licence reflects the regulatory policies set out in our Final Proposals in an accurate and unambiguous manner.

The process of making formal licence modifications to reflect Final Proposals in NGG NTS's licence proceeded in two stages. The current set of licence modifications represents the second stage of that process, and completes the implementation of the full TPCR price control package.

As part of the implementation process, we consulted on the proposed modifications to NGG's licence. We conducted two informal consultations and two formal statutory consultations under section 23 of the Gas Act 1986 (Gas Act). The second statutory consultation closed on 28 August 2007.

Representations

We carefully considered responses to the statutory (and informal) consultations, in which stakeholders expressed a variety of concerns. Following the close of the first statutory consultation and in light of the responses we received, we decided to reissue the proposed licence modifications in order to consult on a number of further material changes.

In response to the second statutory consultation, NGG NTS has expressed its consent to the proposed licence modifications (subject to correction of some typographical errors). E.ON UK has expressed some further concerns about entry and exit capacity arrangements going forward in response to the second statutory consultation. However, it also urged us to implement the licence conditions as soon as practicable, subject to its comments.

Competition Commission review of enduring offtake reform

On 10 July, the Competition Commission quashed two decisions taken by GEMA in relation to modifications to the Uniform Network Code which proposed changes to the arrangements for the offtake of gas from the NTS ("enduring offtake reform").¹

We are presently considering our response to this and will consult on the matter in due course but in order to build in some future flexibility we decided to include in our second statutory licence consultation of 30 July 2007 the licence modifications that would be required to implement enduring offtake reform. This was to avoid extensive redrafting of the respective licence conditions (while we were still reconsidering our position on enduring offtake reform) as well as unnecessary delay in the implementation of the rest of the TPCR price control package. Furthermore, the respective licence conditions include provisions to allow us to "switch off" enduring offtake reform (as required).

We believe our approach adequately addresses the concerns about exit capacity arrangements raised by E.ON UK in response to our second statutory consultation.

Further consultation on NTS entry capacity baselines

On 27 July, we issued an open letter in which we explained that given the scale of the changes to baseline levels between Updated and Final Proposals and the level of concern that was expressed we were going to re-consult on one aspect of the new TPCR policies, namely the gas entry baselines.

However, we consider it is nevertheless appropriate at this point to implement the full TPCR package as set out in our December 2006 Final Proposals, and use this as a basis to make further potential licence modifications in future (if required).

Our decision

Following the close of the second statutory consultation and in light of the responses we received and the other developments explained above, we consider that no further material changes are required in order to implement the full TPCR price control package.

We have therefore decided to implement the licence modifications that we proposed and consulted on through our second statutory consultation (with correction of the typographical errors pointed out by NGG NTS). This document sets out our reasons for that decision as required under section 38A of the Gas Act. The licence modifications apply with retrospective effect from 1 April 2007.

¹ An appeal under section 173 of the Energy Act, Decision and Order of the Competition Commission, 10 July 2007.

1. Background

Implementation of TPCR

1.1. We issued our Final Proposals for the Transmission Price Control Review (TPCR) on 4 December 2006.² Final Proposals were issued following a lengthy consultation exercise which started in July 2005³, and were accepted in principle by National Grid on 15 December 2006.

1.2. The process of modifying the licence of NGG in respect of the NTS (NGG NTS) in order to implement the TPCR Final Proposals has proceeded in two stages. The first stage was completed on 30 March 2007 and involved implementing⁴ the gas entry baselines, in order to ensure that the commercial framework from 1 April 2007 was aligned with the revised regulatory regime. We explained the two stage process and our position on gas entry baselines in the section 38A document that we issued at the time.

1.3. The current licence modifications, made under our decision of 5 September 2007 to modify the gas transporter licence under section 23 of the Gas Act, implement the remaining aspects of the TPCR price control package for NGG NTS. These modifications in respect of NGG NTS's licence will apply with retrospective effect from 1 April 2007.

1.4. Prior to undertaking the two stage process set out above, we issued two informal licence drafting consultations⁵ concerning proposed modifications to NGG NTS's licence, in November 2006 and January 2007 respectively. We carefully considered responses to these consultations for the purpose of progressing the implementation process.

Interaction with review of system operator (SO) incentives

1.5. We followed a separate process for reviewing certain aspects of NGG NTS's system operator incentives, which took place alongside the TPCR project. Final Proposals under this separate process were issued⁶ on 21 March 2007 and licence modifications for NGG NTS were implemented⁷ on 19 April 2007.

² Ref. No. 206/06.

³ Ref. No. 172/05.

⁴ Ref. No. 61/07.

⁵ Ref. No's 197/06 and 16/07.

⁶ Ref. No. 43/07.

⁷ Ref. No. 89/07.

Statutory consultation process

1.6. As part of the second stage of the TPCR implementation process explained above, we issued two statutory consultations⁸ under section 23 of the Gas Act 1986. The reasons for consulting twice are explained in chapter 2.

1.7. We have carefully considered responses to the consultations in light of our statutory duties. The licence modifications we decided to make on 5 September 2007 reflect our decision to proceed with the second stage of the implementation of the TPCR price control package following these consultations.

Further consultation on NTS entry capacity baselines

1.8. On 27 July 2007, we issued an open letter⁹ in which we explained that we were going to re-consult on one aspect of the new TPCR policies, namely the gas entry baselines.

1.9. We explained in our letter that, following the release of the Final Proposals document, it became apparent that there were significant concerns from a number of industry participants regarding revisions to the baseline levels between our Updated TPCR proposals published in September 2006 and our Final Proposals published in December 2006.

1.10. We recognised that the scale of the changes to the baseline levels as between Updated and Final Proposals was significant in some cases and, at the time of the Final Proposals we gave careful consideration as to whether to re-consult on these numbers. However, in view of the need to ensure certainty around the timing and implementation of the transmission price control, we decided that it was appropriate at the time to issue our Final Proposals with the revised baselines included. Concluding the transmission price control for both electricity and gas transmission was important in ensuring clarity and certainty for industry participants, the transmission companies and customers in a price control period that is likely to see significant network investment being driven by a large number of changes in the sources of supply to the gas and electricity markets. This factor weighed particularly heavily upon us in deciding not to consult further on the baselines last December.

1.11. Nevertheless, having considered this matter further and in view of the concerns that were expressed, we subsequently decided, as explained in our open letter of 27 July, that Ofgem should re-consult on the baseline figures as implemented in the March 2007 decision, and reconsider the matter.

1.12. We also recognised that there were other elements of the entry capacity regime that required further development and might also be impacted by a re-consultation exercise on the baseline numbers. We therefore envisaged that the re-

⁸ Ref. No's 151/07 and 195/07.

⁹ Ref. No. 192/07.

consultation on baselines should be incorporated within a broader entry capacity regime development and consultation project that encapsulates a number of other work areas including:

- capacity substitution and the preparation of a substitution methodology;
- incremental capacity release methodology;
- development of enduring arrangements for trade and transfer;
- NGG NTS's transmission capacity charging methodology in relation to the treatment of spare capacity; and
- if necessary, NGG NTS's entry capacity buy-back incentive.

1.13. Although we will be re-consulting on gas entry baselines as explained above, we consider it is nevertheless appropriate at this point to implement the full TPCR package as set out in our December 2006 Final Proposals. This is in order to ensure the continued and effective regulation of NGG NTS's network monopoly business, in order to protect the interests of consumers, without undue delay. We will use the revised licence conditions for NGG NTS as a basis to make further potential licence modifications in future (if required), in light of our decision to re-consult on gas entry baselines.

Document overview and purpose

1.14. Chapter 2 summarises responses to the statutory consultations we conducted, and sets out Ofgem's views.

1.15. Chapters 3 to 5 of the document set out the reasons for Ofgem's decisions on implementation of the TPCR Final Proposals in relation to each of the following Special Conditions applicable to the NTS licensee:

- Amendments to Standard Special Conditions A37 and A40 (Special Condition 1B)
- Revenue restriction definitions (C8A)
- NTS transportation owner activity revenue restriction (C8B)
- NTS system operation activity revenue restriction (C8C)
- NTS gas entry incentives, costs and revenues (C8D)
- NTS gas exit incentives, costs and revenues (C8E)
- NTS system operator external incentives, costs and revenues (C8F)
- NTS system operator internal incentives, costs and revenues (C8G)
- Allocation of revenues and costs (C9)
- Excluded services (C10)
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- Licensee's methodology for determining the release of NTS exit capacity volumes (C18)
- Network model (C24)

- Promoting competition in the provision to the licensee of operating margins services (C25)

1.16. Chapter 3 covers Special Condition C8D, chapter 4 covers Special Condition C8E, and chapter 5 covers all the remaining Special Conditions listed above. These three chapters set out our reasons, required under section 38A of the Gas Act, for modifying the Special Conditions of NGG NTS's licence and also how we envisage the policy will work in practice.

1.17. The appendices to this document contain a summary of the Authority's powers and duties, a glossary and a feedback questionnaire.

1.18. For the avoidance of doubt, if any issues arise regarding the interpretation of the licence modifications addressed in this document and the licence text, the licence text set out in the decision to modify NGG NTS's licence dated 5 September 2007 shall prevail.

2. Responses to statutory consultations and Ofgem's views

2.1. Ofgem received:

- three responses to the first¹⁰ statutory consultation; and
- two responses to the second¹¹ statutory consultation.

2.2. This chapter summarises these responses and sets out Ofgem's views in light of the responses.

Responses to first statutory consultation

2.3. We received responses to the first statutory consultation of 25 June from NGG NTS, Wales and West Utilities (WWU) and E.ON UK.

2.4. NGG NTS responded with a table of detailed comments on the amendments that they believed were necessary to implement the gas transmission price control. They categorised their comments in order to help Ofgem consider the materiality of the proposed changes. NGG NTS considered that there were material issues which needed to be addressed in respect of aspects of the drafting for Special Conditions C8B, C8C, C8D and C8E contained in the first statutory consultation document.

2.5. WWU commented on the disapplication provision in paragraph 4 of Special Condition C8D, saying that it would not be appropriate to mirror this provision in gas distribution, and identified a small number of typographical errors.

2.6. E.ON UK expressed concerns about the proposed licence obligations relating to entry capacity substitution. Although being generally supportive of the proposed obligation, E.ON UK said it did not support imposing the obligation before winter 2007/08. E.ON UK observed that there had been a distinct lack of dialogue between stakeholders on the issue of capacity substitution and that the proposals had created significant regulatory uncertainty and unease in the market.

2.7. E.ON UK proposed delaying implementation of the capacity substitution obligation until 2008, and did not consider that such a delay would be to the detriment of the economic and efficient operation of the NTS or the wider market. E.ON UK also referred to the increasing complexity of the auction regime and the large number of concurrent changes. It argued that the significant confusion and unnecessary uncertainty that could be introduced by imposing this obligation before winter 2007/08 could be very damaging to the continued efficient operation of the market.

¹⁰ Ref. No. 151/07.

¹¹ Ref. No. 195/07.

2.8. Finally, E.ON UK pointed out that unlike the effects of entry capacity transfer and trade, the effects of substitution are permanent and long-term, and that therefore it is important to ensure that the solution is effective and fully evaluated by industry before implementation. E.ON UK did not believe this was achievable in the short space of time remaining.

2.9. These responses were non-confidential and have been published on the Ofgem website¹².

Ofgem's approach following first statutory consultation

2.10. Following the close of the first statutory consultation on 23 July, we carefully considered the responses in light of our statutory duties. In light of the perceived materiality of some of the comments, in particular those raised by NGG NTS, we decided to make further changes to the text of the proposed licence modifications, and to reissue the full revised text for a second round of statutory consultation.

2.11. In light of E.ON UK's comments on the entry capacity substitution obligation and further internal review of the proposed conditions, we decided to amend the text of Special Condition C8D in order to provide some further flexibility regarding the way in which this new obligation could come into effect.

2.12. We consider that the entry capacity substitution obligations remain part and parcel of the overall price control package to which NGG NTS have expressed their consent, and explain again our rationale for this new policy in this document¹³. However in our open letter¹⁴ of 27 July, which we issued following the close of the first statutory consultation, we said that we do not consider that it would be appropriate for NGG NTS to implement its capacity substitution methodology or undertake capacity substitution processes for the forthcoming long term auctions currently scheduled for September 2007, for the reasons set out in that letter. We also stated in that letter that we would expect any such process to be in place for next year's long term auctions.

2.13. We issued our second section 23 statutory consultation on 30 July.

Responses to second statutory consultation

2.14. We received responses to the second statutory consultation from NGG NTS and E.ON UK.

2.15. NGG NTS confirmed on 9 August that, subject to the correction of four typographical errors in Annex A to Special Condition C8D, it consented to the

¹² www.ofgem.gov.uk

¹³ Paragraph 3.20.

¹⁴ Ref. No. 192/07.

modification of its NTS licence in the manner specified in the section 23 notice (of 30 July).

2.16. E.ON UK expressed concerns that the licence negotiations have continued far beyond the anticipated implementation date of April 2007. It considers that the ongoing uncertainty and confusion surrounding the detail of the new licence obligations has had an adverse impact on the efficient development of both capacity trade and transfer proposals and capacity substitution. E.ON UK therefore urged Ofgem to implement the licence proposals as soon as practicable, subject to the comments it provided in its response, in order to address the current uncertainty faced by market participants.

2.17. E.ON UK welcomes Ofgem's recent decision to delay application of the proposed licence obligation relating to entry capacity substitution and thereby allow sufficient time for industry consultation and development.

2.18. E.ON UK continues to support the proposed licence obligations relating to entry capacity transfer and trade, particularly given the much reduced scope of the proposals to just winter months (with a view to developing further proposals in due course). E.ON UK expressed significant concerns that any more delay in implementing the licence obligations will almost certainly result in critical winter months being excluded from the transfer and trade process due to time constraints.

2.19. Finally, E.ON UK commented that the licence drafting in relation to the exit capacity arrangements makes numerous references to "exit flow flexibility" and that Ofgem clearly envisages the implementation of exit flow flexibility arrangements for all users at some date in the future. E.ON UK highlighted that the Competition Commission has quashed UNC modification proposal 0116V, which included introduction of an exit flow flexibility capacity product for shippers, and added that it cannot be certain that these arrangements will, in fact, be introduced at a future date. E.ON UK believes that all references to exit flow flexibility in the context of applying such a product to shippers should, therefore, be removed from the proposed licence drafting.

2.20. We will publish these responses on the Ofgem website¹⁵.

Ofgem's decision following second statutory consultation

2.21. Following the close of the second statutory consultation, we carefully considered the responses in light of our statutory duties and have decided that no further material changes are required in order to implement the full TPCR package set out in our December 2006 Final Proposals.

2.22. We noted in particular E.ON UK's concerns about the references to exit flow flexibility. However we believe the approach we adopted, as explained in chapter 4

¹⁵ www.ofgem.gov.uk

(in the section on "Competition Commission review of enduring offtake reform") adequately addresses these concerns.

2.23. We have therefore decided to implement the licence modifications that we proposed and consulted on through our second statutory consultation (with correction of the typographical errors pointed out by NGG NTS). This document sets out our reasons for that decision as required under section 38A of the Gas Act. The licence modifications will apply with retrospective effect from 1 April 2007.

3. NTS gas entry incentives, costs and revenues (Special Condition C8D)

3.1. This chapter explains our reasoning in relation to Special Condition C8D (NTS gas entry incentives, costs and revenues). We discuss in turn the following areas relating to our revised policy for gas entry:

- entry capacity release obligations;
- entry capacity substitution;
- entry capacity transfer and trade;
- entry capacity revenue calculations;
- entry capacity revenue drivers; and
- entry capacity buyback schemes.

Entry capacity release obligations

3.2. NGG NTS will be obliged to offer for sale a certain volume of unsold obligated entry capacity at each entry point, for use of that capacity by gas shippers at a future date. Previously, these obligations were set out across different paragraphs in the NTS licence, but for transparency reasons we have brought them together in one place, namely in paragraph 9 of Special Condition C8D.

3.3. The rationale for the policy is to set out clearly what NGG NTS's entry capacity release obligations are in return for which they receive funding under the TO and SO price control formulae in Special Conditions C8B and C8C respectively (through the TOMR and SOMR terms in those conditions).

3.4. The policy is still broadly similar to that previously reflected in the NTS licence, in that the volume of unsold obligated entry capacity that NGG NTS is obliged to offer for sale is made up of various components, such as baseline obligated entry capacity and incremental obligated entry capacity (previously known under slightly different names). However we have redefined and reclassified these components in light of various new policies, in particular the new policy for entry capacity substitution.

3.5. Under the revised formulation of the capacity release obligation, NGG NTS will be required to offer for sale a volume of unsold obligated entry capacity which is made up of:

- non-incremental obligated entry capacity, broadly consisting of (a proportion of) baseline obligated entry capacity and two terms that adjust non-incremental obligated entry capacity for entry capacity substitution; *plus*
- cumulative funded incremental obligated entry capacity, consisting of incremental obligated entry capacity released through long term system entry capacity auctions that took place prior to 1 April 2007 and (the funded portion of) any new

incremental obligated entry capacity that may be released through such auctions after 1 April 2007; *minus*

- sold obligated entry capacity, consisting of obligated entry capacity of the previous two forms (ie, non-incremental obligated entry capacity and cumulative funded incremental obligated entry capacity) that has already been sold in previous auctions of entry capacity.

3.6. Non-incremental obligated entry capacity receives funding through the TO price control. Cumulative funded incremental obligated entry capacity receives funding through the SO price control, for at least 5 years from the date at which the capacity is contractually delivered.¹⁶

3.7. The entry capacity release obligations are essentially forward looking from 1 April 2007, in that they define what NGG NTS is obliged to offer for sale in entry capacity auctions as of that date. However paragraph 9(c)(i) of Special Condition C8D also contains the historical gas entry baseline volumes that applied prior to 1 April 2007. Although these baseline volumes no longer determine what NGG NTS is obliged to offer for sale from 1 April 2007, we have left them in this paragraph because they are needed to define the TO and SO revenues that NGG NTS earns from the sale of entry capacity (as set out in paragraphs 6 to 8 of Special Condition C8D).

3.8. The entry capacity release obligation policy set out above is reflected in the gas entry auction regime, as the volumes of unsold obligated entry capacity that NGG NTS is obliged to offer for sale under its licence are intended to feed into the provisions for gas entry auctions under the Uniform Network Code (UNC).

Holding back entry capacity for the short term

3.9. Under its entry capacity release obligations, NGG NTS is obliged to hold back 10 per cent of its baseline obligated entry capacity for release in the shorter term. Previously this figure was 20 per cent.

3.10. Our rationale for the change in policy was set out in our Updated Proposals of September 2006¹⁷. We observed that, although the previous objective of allowing new entrants to gain access to entry capacity without having to wait until new capacity can be constructed remained important to us, there is a potential cost to holding back capacity from the long term auctions, for example if it dilutes or distorts incentives to buy long term capacity. We also recognised the effect of our new proposals to extend the ways in which new entrants can gain access to capacity in the short term, namely through the transfer and trade of capacity. This is why we proposed to reduce the proportion of capacity held back for release in the shorter term from 20 per cent to 10 per cent, with an intention to remove the concept

¹⁶ The formula for non-incremental obligated entry capacity also includes an additional term that ensures that, five years after the date at which the capacity is contractually delivered, new incremental obligated entry capacity released through auctions after 1 April 2007 becomes non-incremental obligated entry capacity. An equivalent provision existed in the NTS licence previously.

¹⁷ Paragraph 10.10.

completely as part of the next price control review. We will keep this future policy intent under review in light of the ongoing processes to put in place new arrangements for entry capacity transfer, trade and substitution.

3.11. The revised policy has been implemented, in paragraph 9(c) of Special Condition C8D, simply by incorporating a multiplicative factor for the shorter term of 0.9 on the new term for baseline obligated entry capacity (and leaving in a factor of 0.8 on the old term).

Clearing allocations and withholding of entry capacity

3.12. Under paragraph 9(e) of Special Condition C8D, NGG NTS will be obliged to use all reasonable endeavours to offer for sale all obligated entry capacity (ie, the sum of unsold and sold obligated entry capacity as described above) in at least one clearing allocation. A clearing allocation is an allocation which either results in all capacity offered for sale being sold or has a reserve price of zero.

3.13. This policy has been broadly retained in a form similar to that previously set out in the NTS licence, except that we have included a provision to enable the Authority to "otherwise direct the licensee" in respect of this obligation (instead of just having the reasonable endeavours obligation to have at least one clearing allocation). We remained concerned about the possibility of NGG NTS unreasonably withholding entry capacity from the market, which was the rationale for the clearing allocation policy previously reflected in the NTS licence. However the additional provision for the Authority to direct otherwise was added in case the Authority reaches the view, based on convincing evidence produced by the licensee or on other grounds, that NGG NTS would not be unreasonably withholding entry capacity from the market without this provision.

Incremental obligated entry capacity proposal

3.14. The regulatory and commercial regime for gas entry continues to include arrangements that enable gas shippers to bid for additional firm entry capacity in the long term auctions over and above the baseline volumes. When bidding in the auctions is sufficiently strong, NGG NTS can apply to the Authority for the additional firm entry capacity to be treated as incremental obligated entry capacity.

3.15. More specifically, and as set out in paragraph 9(f) of Special Condition C8D, when NGG NTS believes that there is demand for additional firm entry capacity, as a result of calculations carried out in accordance with its "incremental entry capacity release (IECR) methodology statement" (established pursuant to Special Condition C15), it must submit to the Authority an "incremental obligated entry capacity proposal" for each entry point with additional demand for firm entry capacity.

3.16. Previously the NTS licence also contained provisions for such proposals but we had to revise these in light of the new policy for entry capacity substitution and to ensure that the split between TO and SO funding continues to work appropriately.

So as part of its incremental obligated entry capacity proposal, NGG NTS must now set out whether it wants the additional firm entry capacity to be treated as either:

- funded incremental obligated entry capacity; or
- non-incremental obligated entry capacity provided by entry capacity substitution.

3.17. Funded incremental obligated entry capacity results in NGG NTS receiving SO funding for 5 years through the gas entry capacity revenue drivers (under paragraph 2 of Special Condition C8D).¹⁸ NGG NTS already receives TO funding (under Special Condition C8B) for non-incremental obligated entry capacity provided by entry capacity substitution, because this involves unsold non-incremental obligated entry capacity being moved between entry points.

3.18. Paragraphs 9(f) to 9(p) of Special Condition C8D set out the revised arrangements whereby bidding activity in the long term auctions can result in changes to NGG NTS's obligations to offer for sale unsold obligated entry capacity at individual entry points. The process whereby the incremental obligated entry capacity proposal gets implemented by the licensee has been revised accordingly.

Entry capacity substitution

3.19. The gas entry revenue drivers only provide additional funding to NGG NTS (through the SO price control) for additional firm entry capacity that cannot be provided by substitution of unsold non-incremental obligated entry capacity from elsewhere on the network. Entry capacity substitution is the process by which unsold non-incremental obligated entry capacity is moved from one or more entry points to meet demand for incremental obligated entry capacity at another entry point (as set out in Special Condition C8A). At the start of the 2007/12 price control period, non-incremental obligated entry capacity will consist solely of baseline obligated entry capacity.

3.20. The rationale for this new policy of entry capacity substitution is to reduce the risk of not fully utilising the existing network assets, by enabling unsold non-incremental obligated entry capacity on the network to be moved to an entry point where users have provided a signal for incremental obligated entry capacity through the long term system entry capacity auctions.¹⁹ This policy helps protect consumers from having to provide extra funding for additional obligated entry capacity that NGG NTS can already provide from the existing physical network (and for which it is already receiving funding through the TO price control). We observed in our Initial Proposals²⁰ of June 2006 that under the previous regime, there were issues of inflexibility, as it did not provide a framework for unsold baseline entry capacity to be reallocated between entry points. We therefore proposed to introduce formal mechanisms to enable existing capacity to be allocated to where it is most in demand.

¹⁸ As described in the section below on entry capacity revenue drivers.

¹⁹ As explained for example in our open letter on entry capacity substitution of 27 June 2007 (Ref. No. 157/07).

²⁰ Paragraphs 11.12 and 11.13.

3.21. Previously extra funding for additional obligated entry capacity under the NTS licence was provided through the gas entry capacity investment incentive, but there was no provision for entry capacity substitution, or some equivalent concept, to affect potentially the amount of funding received by NGG NTS. This is therefore a change in regulatory policy, which has been implemented largely through:

- paragraph 10 of Special Condition C8D, which sets out the new obligations on NGG NTS with respect to entry capacity substitution, including an obligation to have in force an approved entry capacity substitution methodology statement and an obligation to use reasonable endeavours to substitute entry capacity in accordance with that statement; and
- paragraphs 2 and 9 of Special Condition C8D, which set out the implications of introducing the entry capacity substitution policy for gas entry revenue drivers and entry capacity release obligations, respectively.

3.22. Paragraph 10 of Special Condition C8D also sets out default timelines for the capacity substitution obligations coming into effect, which can be amended through directions made by the Authority. In our open letter²¹ of 27 July 2007 we noted that we do not consider that it would be appropriate for NGG NTS to implement its capacity substitution methodology or undertake capacity substitution processes for the forthcoming long term auctions currently scheduled for September 2007, for the reasons set out in that letter. However, we also noted that we would expect any such process to be in place for next year's long term auctions. NGG NTS has not yet formally consulted on a proposed entry capacity substitution methodology statement, although it issued a draft consultation on 18 May 2007.

Entry capacity transfer and trade

Entry capacity transfer

3.23. In our December 2006 Final Proposals²², we proposed to introduce a new obligation on NGG NTS to facilitate the transfer of unsold capacity to meet demands for capacity elsewhere and to establish a methodology for calculating entry capacity transfer rates. Paragraph 11 of Special Condition C8D sets out this policy in further detail, and includes obligations on NGG NTS to have in force an approved entry capacity transfer methodology statement and to use reasonable endeavours to meet any requests from relevant shippers for entry capacity transfer rates calculated in accordance with that statement. In addition, the definition of entry capacity transfer in Special Condition C8A specifies that it involves unsold obligated entry capacity being moved from one or more entry points to meet the demand for firm entry capacity at another entry point where all obligated entry capacity has been sold.

3.24. The rationale behind this new policy of entry capacity transfer is that it is intended to optimise the efficient use of the existing physical network, by enabling users of the network to access unsold obligated entry capacity at donor entry points,

²¹ Ref. No. 192/07.

²² Paragraph 10.7.

for use at another entry point where capacity is sold out. This capacity might otherwise get "sterilised" at the donor entry points.

3.25. NGG NTS must ensure that its entry capacity transfer methodology facilitates the achievement of various objectives set out in paragraph 11(d) of Special Condition C8D, which include: ensuring that entry capacity transfer is effected in a manner which makes effective use of the NTS and which is compatible with the physical capability of the NTS; avoiding material increases in costs (including buyback costs) that NGG NTS reasonably expects to incur as a result of facilitating entry capacity transfer; and facilitating effective competition between shippers and between suppliers.

Entry capacity trade

3.26. In our Updated Proposals²³ of September 2006, we also proposed to introduce a new obligation on NGG NTS to facilitate the transfer of sold capacity between entry points (which we referred to as "capacity trade facilitation"). This new policy was not explicitly referred to in our Final Proposals document, however it was an integral part of the TPCR Final Proposals package for NGG NTS and we have therefore consulted on proposed licence modifications for entry capacity trade and are now implementing the policy.

3.27. Paragraph 12 of Special Condition C8D sets out the entry capacity trade policy in further detail, and includes obligations on NGG NTS to have in force an approved entry capacity trade methodology statement and to use reasonable endeavours to meet any requests from relevant shippers for entry capacity trade rates calculated in accordance with that statement. The definition of entry capacity trade in Special Condition C8A specifies that it involves sold firm entry capacity being moved from one or more entry points to meet the demand for firm entry capacity at another entry point. This could include non-obligated entry capacity (which however is excluded from the entry capacity transfer provisions).

3.28. The rationale behind this new policy of entry capacity trade is similar to that for entry capacity transfer, in that it is intended to optimise the efficient use of the existing physical network, by enabling users of the network to move sold firm entry capacity between entry points.

3.29. NGG NTS must ensure that the entry capacity trade methodology facilitates the achievement of various objectives set out in paragraph 12(d) of Special Condition C8D, which are equivalent to the objectives for entry capacity transfer described above.

²³ Paragraphs 10.25 to 10.27.

Implementation of entry capacity transfer and trade policies

3.30. NGG NTS and industry have already been considering methodologies for entry capacity transfer and trade (as required in accordance with NGG NTS's proposed new licence obligations) and UNC modifications. NGG NTS has consulted twice on a combined entry capacity transfer and trade methodology statement and its most recent consultation closed on 28 August 2007.

3.31. Our views on the implementation of the entry capacity transfer and trade policies and the development of the regime ahead of winter 2007/08 were set out in our earlier open letter²⁴ of 19 June 2007. We also noted subsequently, in our open letter²⁵ of 27 July 2007, that enduring arrangements for capacity transfer and trade applying from April 2008 onwards will require further development, and asked NGG NTS to take on the role of coordinating and managing this work (as part of a broader entry capacity regime development and consultation project).

Entry capacity revenue calculations

3.32. Paragraphs 6 to 8 of Special Condition C8D set out how revenues from the sale of entry capacity should be calculated by NGG NTS, to feed into:

- the TO revenues earned (TOR) term in paragraph 2(a) of Special Condition C8B;
- the SO revenues earned (SOR) term in paragraph 2(a) of Special Condition C8C; and
- certain revenue terms featuring in the "entry capacity operational buyback performance measure" in paragraph 3(b) of Special Condition C8D.²⁶

3.33. For this purpose, paragraph 7(a) of Special Condition C8D sets out how NGG NTS should attribute sold firm entry capacity to three different categories, namely sold non-incremental obligated entry capacity, sold cumulative funded incremental obligated entry capacity and sold non-obligated entry capacity. Paragraph 7(b) of Special Condition C8D sets out how subsequently, based on this categorisation of sold firm entry capacity, the licensee shall attribute the total revenue derived from the sold firm entry capacity to three categories of revenue, namely revenue from sales of non-incremental obligated entry capacity, revenue from sales of cumulative funded incremental obligated entry capacity, and revenue from sales of non-obligated entry capacity. This is subject to the price allocation rules set out in paragraph 7(b)(iv) of Special Condition C8D.

3.34. The formulae in paragraph 7(a) that NGG NTS must use to calculate the volumes of the three categories of sold firm entry capacity have been revised in order to reflect the new terms for NGG NTS's capacity release obligations contained in paragraph 9 of Special Condition C8D as well as the new policy for entry capacity substitution (both explained above). The intention behind the price allocation rules

²⁴ Ref. No. 148/07.

²⁵ Ref. No. 192/07.

²⁶ See paragraph 3.61 which provides an explanation of the term "entry capacity operational buyback performance measure".

set out in paragraph 7(b)(iv) of Special Condition C8D was to retain the equivalent text²⁷ previously set out in the NTS licence.

Entry capacity revenue drivers

Funding for new incremental obligated entry capacity

3.35. Paragraph 2 of Special Condition C8D provides for NGG NTS to receive additional funding (through the SO price control) for additional firm entry capacity that cannot be provided through entry capacity substitution. Such funding would be provided in respect of any new incremental obligated entry capacity that may be released through long term entry capacity auctions occurring after 1 April 2007 (following implementation of a proposal for such capacity).

3.36. These funding arrangements (known as gas entry capacity "revenue drivers") were explained in paragraphs 10.9 to 10.13 of our Final Proposals document. We proposed to introduce revenue drivers for gas entry capacity in light of changing patterns in the supply of gas and uncertainty about the additional investment required on the NTS over the duration of the next price control period. The revenue drivers are intended to adjust automatically NGG NTS's revenue allowances consistent with the efficient provision of the additional firm entry capacity, in response to new demand at specific entry points. Together with the entry capacity buyback schemes described below, they provide incentives to NGG NTS to reach an efficient trade-off for the benefit of consumers between investing in new network assets in order to provide the additional firm entry capacity (when it considers this to be the most efficient way of providing the capacity) and not investing in new network assets and potentially having to buy back entry capacity (in situations where it considers this would lead to a more efficient outcome).

3.37. Revenue driver funding under the SO price control is provided for 5 years from the contractual delivery date of any new capacity. We will undertake an assessment of the efficiency of NGG NTS's investment decisions to provide new capacity as part of our next price control review. NGG NTS will subsequently be allowed to recover through its TO price control the (depreciated) costs of all investment which, in the opinion of the Authority, have been efficiently incurred.

3.38. Paragraph 2 of Special Condition C8D sets out a revenue driver function for each entry point, which allows the marginal unit revenue allowance to vary depending on the magnitude of the capacity increase. The function also incorporates an ex ante inflation adjustment for increases in steel and construction prices (above the general rate of inflation as measured by the retail price index).

3.39. We indicated in our Updated Proposals document²⁸ that the revenue drivers would not necessarily be used, as they were under the 2002/07 price control period, in the user commitment test that NGG NTS applies to determine the release of

²⁷ As contained in paragraph 14(5)(i) of the old Special Condition C8B.

²⁸ Paragraph 10.28.

incremental obligated entry capacity. NGG NTS has since implemented a revised methodology for the release of incremental entry capacity, in which the user commitment test is indeed no longer a function of the revenue drivers for gas entry capacity.

Funding for past incremental obligated entry capacity

3.40. Previously, funding for additional firm entry capacity under the NTS licence was provided through the gas entry capacity investment incentive. This incentive has been retained in Annex A of Special Condition C8D, in order to provide funding for incremental obligated entry capacity that came about as a result of bidding in long term auctions prior to 1 April 2007.

3.41. The new provisions for funding of additional firm entry capacity represent a simplification over the previous arrangements, in that the funding that NGG NTS receives is no longer a function of the auction revenues that it earns subsequently (subject to a cap and a collar). However, for regulatory consistency reasons funding for incremental obligated entry capacity released through auctions prior to 1 April 2007 will continue to be provided through the gas entry capacity investment incentive (as retained in Annex A).

Entry capacity buyback schemes

3.42. When NGG NTS expects it is unable to deliver firm entry capacity it has sold previously, for example when there are temporary physical constraints on the network, under the UNC it must buy back that capacity until it is able to meet its obligations.

3.43. All (unsold) obligated entry capacity that NGG NTS is obliged to offer for sale under paragraph 9 of Special Condition C8D is firm entry capacity. NGG NTS can also offer for sale non-obligated entry capacity, which is firm entry capacity offered for sale over and above the obligated entry capacity levels, or interruptible entry capacity, in accordance with the interruption provisions of the UNC.

3.44. Under paragraphs 3 to 5 of Special Condition C8D, NGG NTS's allowed revenues under its SO price control get adjusted in light of the costs it incurs as a result of entry capacity constraint management (including buyback costs) and the revenues it earns from the sale of various form of entry capacity, including non-obligated entry capacity and interruptible entry capacity.

Separate buyback schemes

3.45. One key policy change in relation to entry capacity buyback is that the buyback scheme previously set out in the NTS licence has²⁹ been split into three separate

²⁹ The split between the operational and incremental buyback incentive was consulted on through the TPCR process (Final Proposals Ref. No. 206/06), while the introduction of the

incentive schemes (contained in paragraphs 3, 4 and 5 of Special Condition C8D respectively), which are described below:

- the entry capacity operational buyback incentive;
- the entry capacity incremental buyback incentive; and
- the Milford Haven entry capacity buyback incentive.

3.46. The rationale for proposing separate incremental and operational buyback schemes is that the risks NGG NTS faces in investing to release incremental capacity are fundamentally different to the risks that NGG NTS faces in managing the risks of buyback on the prevailing network. Setting two incentive schemes provides more effective and focused incentives on NGG NTS to operate efficiently. The rationale for the separate buyback scheme for Milford Haven was set out in our July 2006 decision document³⁰ about this scheme.

Incremental entry capacity buyback scheme

3.47. The incremental entry capacity buyback scheme is intended to incentivise the timely and efficient delivery by NGG NTS of funded incremental obligated entry capacity resulting from long term auctions held after 1 April 2007.

3.48. The scheme exposes NGG NTS to the full costs of entry capacity constraint management (including buyback costs) that are associated with not delivering the capacity in time, subject to monthly caps of £4m and an annual cap of £36m. Within these caps NGG NTS is not allowed to recover (through its SO price control) the entry capacity constraint management costs that it incurs, although beyond the caps it is. The scheme is set out in paragraph 5 of Special Condition C8D.

Delivery lead time and gas entry permits

3.49. Our Final Proposals³¹ increased the default lead time for contractual delivery of incremental obligated entry capacity from 36 to 42 months. This change is reflected in the text of paragraphs 3(f) to 3(i) of Special Condition C8D. We also proposed a new process to allow NGG NTS to vary the lead time so that it could be shorter or longer than the default lead time of 42 months, through a system of "gas entry permits". Under this system, NGG NTS receives an initial allowance of gas entry permits at the start of the price control period, and can either earn additional permits (by agreeing in advance of a long term auction to deliver capacity earlier than the default lead time) or use up its allowance of permits (by announcing in advance of a long term auction to deliver capacity later than the default lead time). Additional permits can only be earned by NGG NTS if the full amount of incremental obligated entry capacity (ie, funded incremental obligated entry capacity plus non-incremental obligated entry capacity provided by entry capacity substitution) has been delivered

Milford Haven buyback incentive was consulted on separately (Final Proposals Ref. No. 118/06).

³⁰ Ref. No. 118/06.

³¹ Paragraph 10.19.

earlier than the default lead time, as addressed by paragraphs 3(g) to 3(i) of Special Condition C8D.

3.50. This system of gas entry permits underlies the licence text in paragraphs 3(g) to 3(i) of Special Condition C8D. They set the permit "granularity" to units of 1 GWh per day for each one month period (of entry capacity whose lead time is being varied). This is a change from Final Proposals, which expressed permit granularity in units of 100 GWh per day for each six month period.³² We believe this change will result in a more flexible system of gas entry permits, which is why we have made this change.

3.51. In our Final Proposals³³ we also proposed that each initial permit that remains unused at the end of the 2007/12 price control period would have a residual value of £3m per permit. (This was under a proposed system with 12 initial permits of 100 GWh per day for each six month period, which would therefore result in a total residual value of at most £36m.) We subsequently clarified that the permits that NGG NTS earns by agreeing to deliver capacity earlier than the default lead time would also have a residual value and that the total residual value at the end of the price control period would be capped at £36m. The residual value of unused permits is reflected in paragraph 3(a) of Special Condition C8C,³⁴ which again uses a permit granularity of 1 GWh per day for each one month period. This means that each unused permit has a residual value of £5,000 per permit, as reflected in paragraph 3(a) of Special Condition C8C.

3.52. The gas entry permit system set out above formalises a process that already existed under the NTS licence previously, whereby NGG NTS could apply to the Authority on a case by case basis to extend the lead time. We believe³⁵ that the revised process provides the appropriate degree of flexibility over the delivery of additional capacity, while also retaining the appropriate incentives on NGG NTS to set challenging delivery targets for itself.

3.53. In terms of implementation of the gas entry permits policy, we would expect NGG NTS to undertake the necessary preparatory work in advance of issuing invitation notices for long term auctions under the UNC (which specify how much capacity will be offered for sale and for when). NGG NTS must reflect any decisions on revised delivery lead times made prior to the auctions in the incremental obligated entry capacity proposals that it submits to the Authority afterwards (in accordance with the provisions of paragraphs 9(f) to 9(p) of Special Condition C8D).

³² The unit in Final Proposals was expressed as follows: "We are proposing to grant NGG NTS 12 permits, with each permit allowing NGG NTS to extend the lead time of up to 100 GW of capacity by up to 6 months" (paragraph 10.19).

³³ Paragraph 10.12.

³⁴ Through the term RLTDVEn.

³⁵ As explained in paragraphs 10.20 and 10.21 of our Final Proposals.

Cap on incremental buyback price

3.54. The incremental buyback scheme also includes an obligation on NGG NTS to use reasonable endeavours to ensure that it does not pay more than 0.52p/kWh/day in respect of entry capacity constraint management costs (including buyback costs) that it incurs in respect of the late delivery of funded incremental obligated entry capacity resulting from auctions on or after 1 April 2007. This obligation is contained in paragraph 5(c) of Special Condition C8D, which also allows for NGG NTS to submit a report to the Authority demonstrating how it considers it has met the obligation.

3.55. The policy is intended to provide additional protection to consumers against the risk of late delivery of funded incremental obligated entry capacity and the potentially high costs that could result from it, as explained in our Third Consultation document³⁶ of March 2006. This protection applies in addition to that provided within the monthly and annual caps on NGG NTS's exposure to costs under the incremental entry capacity buyback scheme. Through our new policy on incremental entry capacity buyback, NGG NTS and shippers share more of the risk of late delivery of new incremental obligated entry capacity than under the previous buyback arrangements, and consumers less.

Milford Haven entry capacity buyback scheme

3.56. The Milford Haven entry capacity buyback scheme was developed separately from the TPCR. However, we explained in our July 2006 decision document on this incentive³⁷ that we intended to bring in the licence modifications necessary to implement this policy alongside other licence modifications relating to the TPCR project.

3.57. The scheme applies to the 650 GWh/d of incremental obligated entry capacity that will be due for contractual delivery at the Milford Haven entry point from October 2007. It is intended to encourage NGG NTS: to provide this new capacity in a timely and efficient manner; to ensure that the costs of any delays are shared between consumers, shippers and NGG NTS in an appropriate way; and to provide a baseline against which shippers and the developers of the Milford Haven LNG supply chain can plan their activities.

3.58. The scheme exposes NGG NTS to 35 per cent of the costs of entry capacity constraint management (including buyback costs) that are associated with not delivering the capacity in time, subject to a year's worth of monthly caps ranging from £2m to £6m per month. Within these caps NGG NTS is not allowed to recover (through its SO price control) the entry capacity constraint management costs that it incurs, although beyond the caps it is.

3.59. The scheme is set out in paragraph 4 of Special Condition C8D, and applies for a year starting from 8 December 2007. The original policy intention was for this year

³⁶ Paragraphs 4.19 to 4.27.

³⁷ Ref. No. 118/06.

to start from 1 October 2007, when the capacity will be due for delivery. However the start date was postponed to 8 December 2007 as a result of delays in the process of granting environmental approval for the project. Without such approval, the project could not proceed.

Operational entry capacity buyback scheme

3.60. The operational entry capacity buyback scheme is intended to incentivise NGG NTS to manage efficiently the risks of buyback associated with the general operation of the prevailing network, including for example buyback associated with planned or unplanned network outages. NGG NTS is also incentivised to release non-obligated entry capacity and interruptible entry capacity under this scheme.

3.61. Under the scheme, NGG NTS's allowed revenues (under its SO price control) are adjusted upwards or downwards depending on how it performs against a notional target allowance of £18m per annum. The performance metric that is used to determine how NGG NTS has performed against this notional target allowance (known as the "entry capacity operational buyback performance measure") is expressed in terms of entry capacity constraint management costs incurred by NGG NTS net of certain revenues earned by NGG NTS, where:

- the entry capacity constraint management costs counted under the metric include all of such costs that are not already counted under the incremental and Milford Haven entry capacity buyback schemes; and
- the revenues that are subtracted from these costs include revenues from the sales of non-obligated entry capacity and interruptible entry capacity (as well as various other forms of entry capacity).

3.62. If the performance metric is greater than the £18m notional target allowance in any year, then the scheme provides for a downward adjustment to NGG NTS's allowed revenues under its SO price control, subject to a downside cap of £18m per year. The downward adjustment will be equal to 50 per cent of the overspend against the notional target allowance. Similarly, if the performance metric is less than the £18m notional target allowance, the scheme provides for an upward adjustment to NGG NTS's allowed revenues, subject to an upside cap of £18m per year. The upward adjustment will be equal to 50 per cent of the underspend against the notional target allowance. Other than these upward or downward adjustments, NGG NTS is allowed to recover through its SO price control all of the entry capacity constraint management costs that fall under this scheme.

3.63. The above features of the operational buyback scheme are set out in paragraphs 3(a) and 3(b) of Special Condition C8D.

Accelerated release of incremental obligated entry capacity

3.64. The operational buyback scheme has an additional feature, set out in paragraph 3(f) of Special Condition C8D, which allows for a further potential upward adjustment to NGG NTS's allowed revenues in case it physically delivers incremental

obligated entry capacity earlier than planned (ie, prior to the contractual delivery date).

3.65. Under the scheme, NGG NTS is permitted to retain 100 per cent of any revenues it earns from the sale of non-obligated entry capacity as a result of earlier than planned delivery of the incremental obligated entry capacity in the form of an additional revenue allowance under its SO price control (subject to certain conditions). This potential upward adjustment is uncapped (other than to the extent implied by the specified conditions). The scheme applies only to new incremental obligated entry capacity resulting from long term auctions taking place after 1 April 2007.

3.66. This new policy measure is described in paragraph 10.26 of our Final Proposals. Its aim is to provide NGG NTS with an extra incentive for timely and efficient delivery of incremental obligated entry capacity, in situations where it is feasible to accelerate the delivery of the capacity (and there is demand from shippers for such capacity prior to the contractual delivery date). The corresponding incentive previously in the NTS licence was weaker, as it was implicitly subject to a 50 per cent sharing factor and an upside cap.

3.67. This additional incentive has been included under the operational buyback scheme in paragraph 3 of Special Condition C8D because it involves the regulatory treatment of revenues from sales of non-obligated entry capacity, which also feature as a revenue item in the operational buyback performance measure (net of revenues earned from this extra incentive).

Review of entry capacity operational buyback scheme

3.68. We observed in our Final Proposals³⁸ that there was genuine uncertainty about likely future buyback prices and volumes and the scope for NGG NTS to sell capacity over and above the baseline levels. We therefore concluded that the most prudent approach from the perspective of consumers was to observe behaviour in the light of our proposed baselines and the proposed capacity transfer methodology, and to review and potentially reset the parameters of the operational buyback scheme after two years.

3.69. Paragraphs 3(j) to 3(m) of Special Condition C8D provide for the review of the operational buyback scheme. They enable the licensee to issue a notice to the Authority to set to zero the value of the standard upward/downward adjustment³⁹ to NGG NTS's allowed revenues under the operational buyback scheme in respect of any periods of time specified in the notice. The additional incentive described above, relating to the accelerated release of incremental obligated entry capacity under paragraph 3(f) of Special Condition C8D, is excluded from this provision. The notice

³⁸ Paragraph 10.25.

³⁹ Provided for in paragraphs 3(a) and 3(b) of Special Condition C8D, through the term EnCOBBIR.

can be submitted on a date after 31 December 2008 and cannot be in respect of periods commencing prior to 1 April 2009.

3.70. It is our intention that NGG NTS should have the opportunity to accept or reject the proposals resulting from our review of the operational buyback scheme even if no change is proposed to the parameters of the scheme. The review, and the opportunity for acceptance or rejection, is expected to be limited only to the parameters of the scheme as defined in paragraph 10.24 of our Final Proposals and not to cover any other aspect of the Final Proposals.

3.71. It is indeed our intention to review and potentially reset the parameters of the operational buyback scheme by the end of the two year period. We also envisage, as indicated in our open letter⁴⁰ of 27 July 2007, that the re-consultation on baselines we intend to undertake should be incorporated within a broader entry capacity regime development and consultation project, which would include (inter alia) work on NGG NTS's entry capacity buyback incentive, if necessary. We noted in the same letter that work on the entry capacity buyback incentive would be managed by Ofgem, and that if we were to propose revisions to baselines then we would also consult on any related proposals to adjust NGG NTS's buyback incentives. If we issued such proposals to adjust NGG NTS's operational gas entry buyback incentives, we would still intend to review and potentially reset the parameters of the operational buyback scheme by the end of the two year period.

Buyback cost allocation rules

3.72. Paragraphs 3(c) to 3(e) of Special Condition C8D define entry capacity constraint management costs, and specify that NGG NTS must attribute these costs between the corresponding cost terms in the three separate entry capacity buyback schemes. They also specify, by cross-referring to paragraphs 3(n) and 13 of Special Condition C8D, that for the purpose of attributing these costs NGG NTS must prepare and submit for approval by the Authority a statement of entry capacity constraint management cost allocation rules. In attributing entry capacity constraint management costs (including buyback costs) between the three separate entry capacity buyback schemes, NGG NTS must apply the rules set out in this statement.

3.73. The aim of these new provisions for buyback cost allocation rules in the NTS licence is for NGG NTS to establish an appropriate set of rules for attributing entry capacity constraint management costs, in light of the separation of the previous entry capacity buyback scheme into three separate schemes. Following Authority approval, we intend to use these rules subsequently to determine NGG NTS's revenue allowances (in the SO price control) under the three separate schemes and to monitor NGG NTS's performance on each of the schemes.

⁴⁰ Ref. No. 192/07.

Aggregate cap

3.74. In our Final Proposals⁴¹, we proposed to cap NGG NTS's total aggregate downside risk under three incentive schemes (ie, the operational and incremental entry capacity buyback schemes plus the incremental exit capacity buyback scheme⁴²) at £48m in any given year. We considered the probability of NGG NTS incurring maximum losses under all three schemes in the same year to be very low. However, we did not consider that this is a risk that we can reasonably impose on NGG NTS given the scale of the impact such an event would have in the year it occurred.

3.75. The aggregate cap across the three schemes is contained in paragraph 3(a) of Special Condition C8C.⁴³ As indicated in our Final Proposals⁴⁴, the Milford Haven entry capacity buyback scheme is outside the scope of this aggregate cap and remains a stand-alone incentive.

⁴¹ Paragraph 10.28.

⁴² See section starting with paragraph 4.39.

⁴³ Through the term BBIOCA.

⁴⁴ Paragraph 10.28.

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

4.1. This chapter explains our reasoning for Special Condition C8E (NTS gas exit incentives, costs and revenues).

4.2. In explaining the reasons for the changes and the practical effect of the amendments to the licence condition, we are building on the explanations provided in the relevant sections of Ofgem's December 2006 Final Proposals and the explanations of the licence drafting provided in the January 2007 licence consultation⁴⁵ on a draft Special Condition C8E.

Competition Commission review of enduring offtake reform

4.3. On 10 July, the Competition Commission quashed two decisions taken by GEMA in relation to modifications to the Uniform Network Code which proposed changes to the arrangements for the offtake of gas from the NTS ("enduring offtake reform").⁴⁶ We are presently considering our response to this and will consult on the matter in due course.

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

4.5. While we recognise that the outcome of the Competition Commission review of the modification proposals for enduring offtake reform means that the proposals within the transmission price control review for the enduring offtake regime cannot be introduced at this time, we have decided to make the changes to Special Condition C8E including the changes that allow for enduring offtake reform to be implemented. We therefore included in our second statutory licence consultation of 30 July 2007 the licence modifications that would be required to implement enduring offtake reform.

4.6. This was primarily to avoid extensive re-drafting of the licence condition at this stage of the process, given that the condition can be effective without re-drafting to remove the enduring offtake provisions.

4.7. The new Special Condition C8E had always been drafted in such a way that it could be effective whether or not enduring offtake reform proceeded and if enduring offtake reform proceeded to a different timetable than anticipated when the condition

⁴⁵ Ref. No. 16/07.

⁴⁶ An appeal under section 173 of the Energy Act, Decision and Order of the Competition Commission, 10 July 2007.

was originally developed. Therefore, we expect to use the provisions within the condition that allow us to keep the provisions relating to enduring offtake reform "turned off" at present, pending the Authority's re-consideration of the enduring offtake reform modification proposals following the Competition Commission's judgement. Once the relevant modification proposals have been re-considered a decision will be taken on whether to activate the relevant licence conditions. This will be dependent upon the nature and extent, if any, of the reforms that are implemented.

4.8. In explaining the provisions of the licence condition below, we have made reference to enduring offtake reform, but these references should be seen in the context of our comments in paragraph 4.7.

Structure of Special Condition C8E

4.9. The new Special Condition C8E is sub-divided into five main paragraphs.

4.10. Paragraph 1 of Special Condition C8E derives the gas exit related allowed revenues and costs (SOExIRct) that feed into the determination of the maximum SO revenue, which is calculated in Special Condition C8C. This is then further sub-divided into the following incentives and cost categories:

- the buy-back and interruptions incentive;
- the constrained storage target;
- the exit capacity investment incentive;
- the long run contracting incentive;
- the non-obligated capacity incentive;
- a mechanism to cap incremental investment buy-back exposure; and
- an allowance for charges foregone.

4.11. There is a final section of paragraph 1 setting out buy back cost allocation rules.

4.12. Paragraph 2 of Special Condition C8E derives NTS gas exit revenues that feed into the determination of actual TO revenue (TORt) and actual SO revenue (SORt), which are calculated in Special Conditions C8B and C8C respectively. Paragraph 3 of Special Condition C8E outlines the capacity release obligations upon NGG NTS. Paragraph 4 of Special Condition C8E outlines the gas exit related statements that the licensee is obliged to provide to the Authority. Paragraph 5 of Special Condition C8E sets out the provisions for NGG NTS to use permits in relation to potential delays or early completions of investment projects in exit capacity. Annex A of Special Condition C8E sets out the NTS baseline exit flat capacity and NTS baseline exit shipper capacity for each offtake point.

4.13. Special Condition C8E contains a number of defined terms. All of the defined terms in the condition are defined in Special Condition C8A.

NTS system operation exit incentives, costs and revenues

Derivation of SOExIRC

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

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

Buy-back and interruptions incentive (ExCBIIrt)

4.16. A buy-back and greater than 15 day interruptions incentive applied to NGG NTS under the previous price control. This was a sliding scale incentive (with a cap and collar) that established a target for the costs of interrupting sites for more than 15 days each year and a target for buy-back costs. Under the current arrangements, additional rebates are given to those sites that are interrupted for greater than 15 days each year. If the costs of these rebates and any capacity buy-backs undertaken by NGG NTS exceeded the target that is set then NGG NTS took a share of these costs.

4.17. For the new price control Ofgem proposed that:

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

4.18. These proposals are intended to continue to provide NGG NTS with appropriate incentives to make efficient decisions regarding interruption and buybacks within the context of its other licence and safety obligations.

4.19. The drafting of sub-paragraph 1(b) of Special Condition C8E retains much of the drafting for the buy-back and interruptions incentive present within the previous Special Condition C8B of the NTS licence, however:

- the value of ExCBIIrt is set to zero for the period from 1 October 2011 (or such date that the Authority may otherwise direct in writing). 1 October 2011 is the updated date for the implementation of any potential enduring offtake reform following the Authority's re-consideration of the relevant offtake modification proposals in the light of the Competition Commission's judgement;

- for the period up to 30 September 2011 (or such date that the Authority may otherwise direct in writing), ExCBBIIRt is defined such that NGG NTS is able to recover relevant buy-back and interruptions costs (ExCBBICPt), but is subject to gains and losses around this cost-recovery level through the application of a sliding scale incentive;
- the component of relevant buy-back and interruptions costs (ExCBBICPt) which relates to buy-back actions takes a value of zero for all days from 1 October 2008 (or such date that the Authority otherwise directs in writing) – this reflects Ofgem's proposal that the buy-back incentive be removed from this date leaving only the greater than 15 day incentive;
- the greater than 15 day target and the incentive collar change on 1 October 2008 (or such date that the Authority otherwise directs in writing); and
- a cap is no longer applied to the sliding scale incentive in the event that the relevant costs incurred (ExCBBICPt) are less than the defined target (ExCBBIITt) as such a provision is not necessary⁴⁷.

4.20. Enduring offtake reform if implemented would take effect part way through a formula year (October). Therefore, in that first year, the incentive schemes in the licence would only cover 6 months even though they have been developed as full year incentives. The licence proportions the non-obligated incremental incentive parameters, e.g. the cap, if enduring offtake reform is introduced part way through a formula year.

Constrained storage target (ExCITt)

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

4.22. In the Final Proposals, we indicated that the constrained storage incentive that currently applies to NGG NTS should be retained in its current form with the incentive target value updated.

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

⁴⁷ For the period up to 30 September 2008, the cap is defined to be equal to the incentive target, however, given that costs can only be positive, the maximum incentive revenue through out-performing the target is the target subject to the 75% sharing factor, which by definition, will be less than the target so the cap can never be binding. Similarly, in the period from 1 October 2008 to 30 September 2010, the target is defined to be zero and, as such, out-performing the target is not possible.

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

Exit capacity investment incentive (ExCIIR_t)

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

- a zonal revenue driver for all capacity increments in the south west quadrant that are less than 15GWh/day in size; and
- nodal, project specific revenue drivers for all projects above this threshold regardless of their location.

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

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

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

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

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

the relevant index for year t-2 and 80% of the relevant index for year t-1, consistent with the assumed profile of capital expenditure prior to project delivery.

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

4.31. The appropriate volume of incremental exit capacity is defined separately for the periods preceding and following 1 October 2011 (or such date that the Authority otherwise directs in writing):

- prior to 1 October 2011, incremental capacity can be remunerated via the zonal revenue driver if the licensee has received a specific user commitment or the Authority has so determined (this latter provision addresses the fact that investment may be appropriate absent a specific user commitment in advance of the introduction of a full user commitment model); and
- on or after 1 October 2011, it is made clear that “NTS obligated incremental exit flat capacity” (the definition of which is provided in Special Condition C8A) can be remunerated through this mechanism.

4.32. In both cases:

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

Long run contracting incentive (ExLRCIRt)

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

4.34. Sub-paragraph 1(e) implements this policy by defining the parameter ExLRCIRt such that it allows the recovery of the costs incurred with respect to the delivery of baseline capacity at the relevant sites with additional up-side or down-side

determined by a sliding scale incentive whereby the licensee bears 50% of all deviations from the target level of costs.

Non-obligated capacity incentive (ExNOCIRt)

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

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

4.36. The intention of this policy is to provide NGG NTS with an incentive to make available as much capacity as possible given system conditions. This policy is implemented through the determination of the parameter ExNOCIRt in sub-paragraph 1(f) of Special Condition C8E which is derived through a sliding scale incentive.

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

4.38. After the Final Proposals were issued, NGG NTS suggested that the revenues from the sale of non-obligated incremental flexibility capacity should be calculated as the volume sold multiplied by a reference price rather than the market price from the proposed auctions of such capacity. As was indicated in our Final Proposals, Ofgem shares the concerns of industry participants with respect to the baseline level of flexibility for the enduring offtake arrangements. In view of these concerns, we believe that it would be preferable to set the flexibility capacity element of this incentive around a reference price rather than a market based price. Therefore, the licence (sub-paragraph 2(b)(i) of Special Condition C8E) includes a £369 reference price⁴⁸ for each GWh of capacity sold each day by NGG NTS.

Cap on incremental investment buy-back exposure (ExXSIBBct)

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

⁴⁸ We note that any rewards are subject to a 50% sharing factor.

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

4.41. Furthermore, and consistent with our Final Proposals, the drafting reflects the implementation of a monthly cap on exposure of £4m and to clarify that the unit price used to inform the derivation of buy back costs should not exceed the administered buy back price.

4.42. As discussed in paragraph 3.74 and 3.75, there is also an aggregate cap on the exposure of NGG NTS under the buyback incentive schemes for entry and exit in any year.

4.43. Sub-paragraph 1(g) includes a requirement for the licensee to use reasonable endeavours not to pay more than 0.52p/kWh for buybacks relating to NTS obligated incremental exit flat capacity or NTS incremental exit flow flexibility until the obligated incremental capacity has been delivered. The licensee can submit a report to the Authority showing how it considers that it has met these obligations and the Authority may direct that the licensee has met the obligations. These provisions are intended to recognise that where there has been a delay to the delivery of obligated incremental capacity the exposure of the licence to buyback costs could be very large, and that it would be appropriate to somewhat limit the exposure.

Charges foregone (ExNTSSICt)

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

4.45. In our June 2006 Initial Proposals consultation and the subsequent September 2006 Updated Proposals, we proposed to remove the incentive in place in relation to charges foregone. This remained unchanged in our Final Proposals and, as such, no incentive is included in the licence drafting presented. However, it remains necessary for the level of charges foregone to feed into the allowed SO revenue until implementation of the enduring offtake regime (at which time the principle of charges foregone and the interruptible discount are expected to no longer apply). As such, sub-paragraph 1(h) retains the drafting currently within the NTS licence in this regard, setting the level of charges foregone (ExNTSSICt) to zero for all days from 1 October 2010 onwards (or such date that the Authority otherwise directs in writing).

Buy back cost allocation rules

4.46. Sub-paragraph (i) of Special Condition C8E clarifies the types of buyback costs that NGG NTS is entitled to recover under the licence. In particular, sub-paragraph (i) states that NGG NTS is only entitled to recover buyback costs associated with delays in the delivery of NTS obligated incremental exit capacity that would be included in ExIBBCT and ExLRCCPt.

Derivation of NTS gas exit revenues

4.47. Paragraph 2 of Special Condition C8E derives NTS gas exit revenues that feed into the determination of actual TO revenue (TORt) and actual SO revenue (SORT) in Special Conditions C8B and C8C respectively.

NTS transportation owner revenues (TOExRt)

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

- TOExRFt, which represents gas exit related TO revenues in the period prior to the implementation of the enduring offtake regime;
- ExNTSSICt, which is the accrued value of charges foregone, which is derived in sub-paragraph 1(g) of Special Condition C8E and discussed above; and
- TOREVBExCt which represents gas exit related TO revenues following the introduction of the enduring offtake regime.

4.49. TOREVBExCt, is derived in sub-paragraph 2(a)(ii). It incorporates all revenues from the sale of NTS baseline exit capacity, both flat and flow flex, in the enduring period. Unlike the previous drafting in Special Condition C8B, revenue from on-the-day sales of baseline capacity are not excluded.

NTS system operation revenues (SOExRFt)

4.50. Sub-paragraph 2(b) derives the gas exit revenues (SOExRFt) that feed into the determination of actual SO revenues in Special Condition C8C. SOExRFt is defined as the sum of:

- SO revenues in the period up to 1 October 2011 (or such date that the Authority otherwise directs in writing), which are defined to be gas exit revenues from the sale of NTS exit shipper capacity net of revenues captured by the term TOExRFt which is discussed above, and therefore include revenues for the sale of incremental and interruptible capacity; and
- SO revenues in the period from 1 October 2011 (or such date that the Authority otherwise directs in writing), which are defined to be the sum of revenues from the sale of NTS obligated incremental exit flat capacity; revenues from the sale of

NTS obligated incremental exit flow flexibility; and revenues from the sale of NTS non-obligated exit capacity.

4.51. Other than the term for the revenue from the sale of NTS non-obligated exit capacity (ExREVNOct), the definition of the other terms is set out in Special Condition C8A. We have explained above how ExREVNOct is calculated.

Capacity release obligations

4.52. Paragraph 3 of Special Condition C8E sets out the capacity release obligations applicable to the licensee in the enduring period. These obligations are consistent with our Final Proposals, and as such impose the following obligations:

- to release baseline capacity up to the end of the gas day;
- to release obligated incremental capacity for which an appropriate user commitment has been received up to the end of the gas day;
- to substitute capacity release obligations (baselines) between nodes such that the level of obligated incremental capacity that requires additional remuneration is minimised (the substitution obligation);
- to revise capacity release obligations (baselines) upwards in the event that the release of obligated incremental entry capacity increases the availability of NTS exit capacity; and
- to use reasonable endeavours to revise capacity release obligations (baselines) for NTS exit capacity flexibility in response to revisions of capacity release obligations for NTS exit flat capacity.

4.53. The overall intention of these capacity release obligations is to ensure that as much exit capacity as NGG NTS is able to make available is made available to shippers, and to ensure that most efficient use of the available capacity. Therefore, NGG NTS is required to make all baseline and obligated incremental capacity available. There is a new obligation to substitute baselines between nodes to minimise the need for obligated incremental capacity. There are also obligations to increase baselines where the release of obligated incremental entry capacity increases the availability of NTS exit capacity, and to use reasonable endeavours to revise baselines for NTS exit capacity flexibility in response to changes in baselines for NTS exit flat capacity.

Statements required from the licensee

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

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

4.55. Each of these statements is considered in turn below.

Capacity baseline statement and request for baseline revision

4.56. Sub-paragraph 4(a) of Special Condition C8E states that the licensee shall be obliged to provide the Authority with a written statement for approval, setting out the level of NTS baseline flat capacity and flow flexibility which is to be offered for sale. This statement is required to be submitted by 1 April 2008 or such later date as the Authority may direct. Sub-paragraph 4(a) also provides that the licensee shall provide the Authority with a written statement of any proposed exit baseline revisions setting out the basis for such revisions consistent with its obligations in this regard (as discussed above). The Authority shall consider such information and shall determine whether to consent to the revisions proposed. Following the granting of any such consent, the licensee shall modify the NTS exit capacity baseline statement incorporating such revisions.

4.57. The licensee's NTS exit capacity baseline statement shall be published within 28 days of being made available to the Authority and the Authority will publish any consents it grants to amending baselines.

4.58. The process and statements for considering baseline revisions are intended to ensure that an appropriate process and proposals, consistent with the methodology statement for baseline revision, the substitution methodology statement and the capacity release obligations, have been followed and made by the licensee. The process and statements also provide transparency to shippers and market participants about changes to the baselines.

Substitution methodology statement

4.59. Sub-paragraph 4(b) of Special Condition C8E states that the licensee shall be obliged before 1 April 2008 or such later date as the Authority may direct, to provide the Authority with a methodology statement for substitution of NTS exit capacity setting out the methodology by which it will determine its proposals for the substitution of NTS exit capacity within the enduring period pursuant to its obligations in this regard (as discussed above). The licensee shall review the statement at least once a year.

4.60. The initial statement and revisions to such a statement shall be subject to a consultation process. Changes to the methodology proposed by the licensee shall apply unless the Authority directs that the changes should not be made, which could be after the Authority has undertaken an Impact Assessment. The licensee will also be obliged to comply with the methodology outlined in this statement in performing substitutions. The licensee shall publish the most up-to-date version of the statement on its website.

4.61. Sub-paragraph 4(b)(iii) includes three objectives that the methodology statement should seek to better meet when initially developed and when it is revised.

4.62. The overall intention of this statement is to provide an appropriate and up-to-date framework for the licensee to substitute NTS exit capacity, within the framework of the objectives for substitution.

Methodology statement for baseline revision

4.63. Sub-paragraph 4(c) of Special Condition C8E states that the licensee shall be obliged before 1 April 2008 or such later date as the Authority may direct, to provide the Authority with a methodology statement for exit baseline revision setting out the methodology by which it will determine its proposals for the revision of baselines within the enduring period pursuant to its obligations in this regard (as discussed above). The licensee shall review the statement at least once a year.

4.64. The initial statement and revisions to such a statement shall be subject to a consultation process. Changes to the methodology proposed by the licensee shall apply unless the Authority directs that the changes should not be made, which could be after the Authority has undertaken an Impact Assessment. The licensee will also be obliged to comply with the methodology outlined in this statement in performing baseline revisions. The licensee shall publish the most up-to-date version of the statement on its website.

4.65. Sub-paragraph 4(c)(iii) includes three objectives that the methodology statement should seek to better meet when initially developed and when it is revised.

4.66. The overall intention of this statement is to provide an appropriate and up-to-date framework for the licensee to make changes to the baselines, within the framework of the objectives for capacity revision.

Statement of incremental investment in the transitional period

4.67. Sub-paragraph 4(d) states that the licensee shall be obliged to provide the Authority with a written statement of any NTS incremental exit capacity that is scheduled for delivery within the transitional period (from 1 October 2008 to 30 September 2011 (or such dates that the Authority otherwise directs in writing)) which leads to depreciation, capex or financing costs being incurred within the next price control period.

4.68. Where the licensee has not received an explicit and appropriate user commitment, the licensee must explain the basis upon which it has reached the view that demand will be sufficient to justify the provision of such NTS exit capacity. In such cases, the Authority shall consider such information and shall determine

whether the NTS exit capacity concerned may be treated, for revenue driver purposes, as if such a user commitment had been received.

4.69. The licensee must publish the statement within 28 days of providing it to the Authority.

Statement of obligated incremental capacity in the enduring period

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

4.71. The licensee is obliged to provide the statement to the Authority by 1 November in each formula year, unless the Authority consents to a later date, and to publish the statement within 28 days of making it available to the Authority.

4.72. This statement is intended to provide transparency to Ofgem, shippers and other market participants about the approach that the licensee has undertaken to decide that investment in obligated incremental capacity is required in the enduring period.

Statement of actual interruption

4.73. Sub-paragraph 4(f) states that the licensee shall be obliged to publish daily statements of actual interruption and the reasons for calling interruption. This obligation currently applies to NGG NTS and is intended to provide transparency to shippers and market participants about the interruption called by NGG NTS.

Project permits

4.74. Paragraph 5 of Special Condition C8E provides the licensee with "permits" in the enduring offtake period that allow it to increase or decrease the lead time for the contractual delivery of NTS incremental flat capacity relative to the default lead time of 38 months, in a similar way to the system of gas entry permits (explained in paragraph 3.49). The licensee is required to notify the Authority each time it varies a lead time for a project.

4.75. As set out in the Final Proposals, Ofgem has provided for NGG NTS to have permits for 365 days for 30 GWh/day for use, on an ex ante basis, during the next price control period. The potential revenue from unused permits feeds in to the calculation of SO revenues in Special Condition C8C. Paragraph 3(c) of Special

Condition C8C specifies that exit permits have a residual value of £274 per permit and that the total residual value at the end of the 2007/12 price control period is capped at £3m.

5. Other Special Conditions applicable to the licensee

5.1. This chapter explains our reasoning in relation to the following Special Conditions:

- Amendments to Standard Special Conditions A37 and A40 (Special Condition 1B)
- Revenue restriction definitions (C8A)
- NTS transportation owner activity revenue restriction (C8B)
- NTS system operation activity revenue restriction (C8C)
- NTS system operator external incentives, costs and revenues (C8F)
- NTS system operator internal incentives, costs and revenues (C8G)
- Allocation of revenues and costs (C9)
- Excluded services (C10)
- Transmission planning code (C11)
- Network output measures (C13)
- Price control revenue reporting and associated information (C14B)
- Licensee's methodology for determining incremental entry capacity volumes (C15)
- NTS performance reporting (C16)
- Exit code statement (C17)
- Licensee's methodology for determining the release of NTS exit capacity volumes (C18)
- Network model (C24)
- Promoting competition in the provision to the licensee of operating margins services (C25)

Amendments to Standard Special Conditions A37 and A40 (1B)

5.2. The amendments to Standard Special Condition A37 and A40 bring into alignment the obligations of the NTS licensee with those already in place for electricity transmission. Furthermore some of the amendments to Standard Special Condition A40 reflect the uniqueness of the NTS. It would therefore not be appropriate to amend the Standard Special Conditions, so amendments have been made through Special Condition 1B instead.

Revenue restriction definitions (C8A)

5.3. The purpose of Special Condition C8A is to provide a set of definitions for the terms used in both the transmission owner (TO) activity and system operation (SO) activity revenue restrictions, which are then subsequently reflected in new Special Conditions C8B and C8C as well as the associated conditions C8D to C8G.

5.4. Given the new and revised licence text in Special Conditions C8B to C8G (as described elsewhere in this document), we have had to amend and delete certain definitions and introduce various new definitions in Special Condition C8A. The main areas of change have been in relation to the definition of the various revised or new gas entry (C8D) and gas exit (C8E) capacity products, as defined under the licence,

and in relation to the introduction of various new policies such as entry capacity substitution, transfer and trade and exit capacity substitution and revision.

5.5. In our statutory section 23 consultation of 30 July (Ref. No. 195/07), we made some further amendments and introduced some extra definitions in Special Condition C8A, relative to our statutory section 23 consultation of 25 June (Ref. No. 151/07). This was in response to comments received to the 25 June statutory consultation as well as further internal review of the proposed licence text. We believe these amendments and new definitions provide further clarification of and consistency with text in other licence conditions and in our TPCR Final Proposals.

NTS transportation owner activity revenue restriction (C8B)

5.6. Special Condition C8B set the maximum revenue that NGG NTS is permitted to recover in respect of its transmission owner (TO) activities. It obliges NGG NTS to use its best endeavours to avoid recovering more revenue from its TO activities (calculated through the term TOR) than its maximum revenue entitlement for those activities (calculated through the term TOMR).

5.7. The principal formula for TOMR in paragraph 3(a) of Special Condition C8B comprises a core element (the TOZ term) and a number of terms linked to incentive and adjustment mechanisms (TOF, TOZA and TOG) which either alter or could potentially alter TOMR. Absent these adjustments, the core revenue allowance increases in line with inflation each year, through an RPI-X term where X has the value of zero. The principal formula also provides for differences between actual revenues (TOR) and allowed revenues (TOMR) in any given year to be reflected in the TOMR term for the next year, adjusted for interest rates (via the TOK term).

5.8. Below we provide some further explanation of the new (and revised) adjustment and incentive mechanisms under the TO price control introduced as part of our TPCR Final Proposals, namely:

- TOZA;
- cost pass-through items;
- the innovation funding incentive;
- the capital expenditure (capex) incentive;
- logged up costs; and
- the capital expenditure safety net.

5.9. The first mechanism (TOZA) features in paragraph 3(a) of Special Condition C8B and the second mechanism is contained in paragraph 3(b). The following three mechanisms feature under the term TOG in paragraph 3(c) of Special Condition C8B. The sixth mechanism involves an adjustment at the start of the next price control, in 2012/13, and does not feature explicitly in the principal formula for TOMR. It is contained instead in a separate paragraph 5 of Special Condition C8B.

TOZA

5.10. The TOZA term reflects a downward adjustment in respect of the Milford Haven pipeline project, worth £9.5 per annum. This £9.5m reflects the annuitised value of the additional revenue entitlement for the Milford Haven project that NGG NTS will already receive under its SO price control, through the gas entry capacity investment incentive (now contained in Annex A of Special Condition C8D).

5.11. The TOZ term in paragraph 3(a) of Special Condition C8B already includes NGG NTS's full revenue entitlement for the Milford Haven project determined by the Authority of £717m (which excludes an additional ring-fenced £75m mentioned in our Final Proposals⁴⁹). The additional revenue entitlement that NGG receives for the Milford Haven project under the SO price control, through the gas entry capacity investment incentive, therefore needs to be netted off the TOZ term. This is what the TOZA term does.

Cost pass-through items (TOF)

5.12. The cost-pass through term (TOF) is another revenue adjustment term in the formula for TOMR. It has been updated in light of the revised arrangements in respect of various cost pass-through items (for example, in relation to business rates, pension deficit costs, conveyance to independent systems and additional security measures).

Innovation funding incentive (IFI)

5.13. Our Final Proposals⁵⁰ introduced an innovation funding incentive (IFI) for gas transmission (and electricity), which was modelled on the scheme already in place for electricity distribution. This incentive makes available ring-fenced funding for research and development (R&D) projects that confirm with industry guidelines for good practice. For gas transmission, it is implemented in paragraph 3(c) of Special Condition C8B, through the term IFI, which is one of the component terms of TOG.

Capex incentive (CxlncRA)

5.14. As explained in our Final Proposals,⁵¹ the capital expenditure (capex) incentive is a fixed strength incentive that defines the exposure that the licensee will face if actual capex differs from our allowances for baseline expenditure under the TO price control. It works in conjunction with our proposals for baseline expenditure, to remunerate investment that is considered highly likely to go ahead, as well as the more uncertain investment projects that will be remunerated by revenue drivers.

⁴⁹ Paragraph 7.34.

⁵⁰ Paragraphs 2.28 and 10.50.

⁵¹ Paragraph 2.27.

5.15. Our Final Proposals⁵² set out the policy position that NGG NTS should be exposed to 25 per cent of any difference between its capex allowance and its actual capital expenditure. We proposed⁵³ to give effect to this by adjusting revenues at the start of the next price control (2012/13). The capex incentive is implemented in paragraph 3(c) of Special Condition C8B, through the term CXINcRA, which is one of the component terms of TOG.

Logged up costs (LC)

5.16. In our Final Proposals, we set out that expenditure for a small number of identifiable, discrete cost items which are dependent on external factors should be agreed in advance with Ofgem and "logged up". For NGG NTS, these items include expenditure incurred in respect of quarry and loss of development claims.

5.17. The adjustment for logged up costs is implemented through paragraph 3(c) of Special Condition C8B, through the term LC, which is one of the component terms of TOG. The value taken by the term LC reflects the total expenditure incurred by the licensee over the 2007/12 price control period (subject to those costs having been efficiently incurred) and involves an adjustment to NGG's revenue entitlement at the start of the next price control period (2012/13).

Capital expenditure safety net

5.18. In our Final Proposals⁵⁴ we also set out a policy to consider proposing adjustments to the capex allowances (and the associated revenue allowances) if a licensee was spending significantly below its allowance for capital expenditure. We proposed that the mechanism would be triggered if at any stage in the five-year price control period annual capital expenditure is more than 20 per cent below the capital expenditure allowance for that year. In addition we proposed that, under the mechanism, a company would retain the benefit of its actions during the price control period up to the time when the mechanism was triggered.

5.19. This "safety net" policy is given effect through paragraph 5 of Special Condition C8B.

NTS system operation activity revenue restriction (C8C)

5.20. Special Condition C8C sets out the maximum revenue that NGG NTS is permitted to recover in respect of its system operation (SO) activities. It obliges NGG NTS to use its best endeavours to avoid recovering more revenue from its SO activities (calculated through the term SOR) than its maximum revenue entitlement for those activities (calculated through the term SOMR).

⁵² Paragraphs 7.1 to 7.12.

⁵³ Paragraph 7.12.

⁵⁴ Paragraphs 7.13 to 7.19.

Restructuring of SO price control

5.21. The SO price control provisions in the NTS licence were previously contained in Part 2 of the old Special Condition C8B. The previous principal formula⁵⁵ for SOMR comprised an incentive revenue term, a cost term, and a term for income adjusting events. The incentive revenue term contained both entry and exit terms (as well as terms related to other aspects of the SO price control), and so did the cost term.

5.22. As part of the licence modifications made on 5 September 2007, the principal formula for SOMR has been restructured relative to the previous one. Under the new structure, incentive revenue and cost terms have been brought together under separate licence conditions for gas entry, gas exit, SO external incentives and SO internal incentives. Consequently, the following new licence conditions have been created from the SO price control provisions previously contained in Part 2 of the old Special Condition C8B:

- Special Condition C8C: NTS system operation activity revenue restriction, which contains the high level provisions relating to the SO price control (principal restriction, SOR, SOMR, disapplication);
- Special Condition C8D: NTS gas entry incentives, costs and revenues, which contains most of the gas entry related provisions;
- Special Condition C8E: NTS gas exit incentives, costs and revenues, which contains most of the gas exit related provisions;
- Special Condition C8F: NTS system operator external incentives, costs and revenues, which contains provisions related to SO external incentives; and
- Special Condition C8G: NTS system operator internal incentives, costs and revenues, which contains provisions related to SO internal incentives.

5.23. The restructured principal formula for SOMR is contained in paragraph 3(a) of the new Special Condition C8C.

5.24. Although Special Conditions C8D and C8E primarily contain entry and exit related aspects of the SO price control, they also include, where we considered this appropriate, entry and exit related aspects of the TO price control (feeding into Special Condition C8B). For example, Special Conditions C8D and C8E specify how revenues from the sale of entry and exit capacity, respectively, should be calculated for the purposes of the entry and exit related components of the TOR term in Special Condition C8B. Special Conditions C8F and C8G, on the other hand, only feed into the high level SO price control provisions of Special Condition C8C.

5.25. We consulted on this licence restructuring exercise through two informal and two formal consultations⁵⁶ and our reasons for the restructuring were set out in the informal consultation documents.

⁵⁵ The old formulation was contained in Special Condition C8B Part 2 paragraph 14(1) and associated paragraphs including 14(2) and 14(3).

⁵⁶ For document references, see "Associated Documents" at the start of this document.

5.26. Below we provide some further explanation of certain new (or revised) high level provisions under the SO price control in Special Condition C8C, introduced as a result of our TPCR Final Proposals, namely:

- aggregate cap on buy-back exposure; and
- cap on residual value of permits.

5.27. Explanations of the new or revised provisions in Special Conditions C8D to C8G are set out elsewhere in this document, in the relevant sections.

Aggregate cap on buy-back exposure

5.28. As explained in paragraphs 3.74, 3.75 and 4.42 of this document, as part of our Final Proposals we proposed an aggregate cap of £48m in any given year on NGG NTS's total buy-back exposure (across gas entry and exit). This cap has been implemented in paragraph 3(a) of Special Condition C8C, through the term BBIOCA.

Cap on residual value of permits

5.29. As explained in paragraph 3.51 of this document, gas entry permits have a residual value of £5,000 per permit and the total residual value at the end of the 2007/12 price control period is capped at £36m. Similarly, paragraph 4.75 explains that gas exit permits have a residual value of £274 per permit and that the total residual value at the end of the price control is capped at £3m.

5.30. The residual values and caps on gas entry and exit permits are reflected in paragraph 3(c) of Special Condition C8C, through the term DELINC. The total residual value for gas entry is captured by the term RLTDVEn, while for gas exit it is captured by the term RLTDVEx. The caps on the total residual value in paragraph 3(c) are adjusted for inflation.

NTS system operator external incentives, costs and revenues (C8F)

5.31. As explained in paragraph 5.22, we have restructured Part 2 of the old Special Condition C8B of the NTS licence into several new licence conditions. Accordingly, the SO external incentive schemes (system balancing, residual gas balancing and quality of information) previously set out in paragraphs 14(8), 14(9) and 14(13) of Part 2 of the old Special condition C8B have moved into a new Special Condition C8F.

5.32. The licence text for the new Special Condition C8F incorporates the licence modifications made to the old Special Condition C8B in April 2007⁵⁷, which revised

⁵⁷ Ofgem (19 April 2007), 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 (Ref. No. 89/07).

certain components of the incentive schemes. An explanation of these changes was set out in our Final Proposals for NGG's system operator incentives⁵⁸.

NTS system operator internal incentives, costs and revenues (C8G)

5.33. As with the NTS system operator external schemes, the licence text for the NTS system operator internal schemes (operating costs, capital expenditure and non-incentivised costs) has also moved as a result of the restructuring of Part 2 of the old Special Condition C8B of the NTS licence.

5.34. The internal incentive schemes previously set out in paragraph 14(10) of Part 2 of the old Special Condition C8B have been moved into new Special Condition C8G. The licence text for Special Condition C8G incorporates changes to the internal incentives that were made at the same time as the licence modifications⁵⁹ for external incentives referenced in paragraph 5.32, and again these changes were explained in our March 2007 Final Proposals for NGG's system operator incentives⁶⁰.

Allocation of revenues and costs (C9)

5.35. This condition has been amended such that the date for submitting information to the Authority is aligned with submission dates of regulatory accounting statements and other cost reports.

Excluded services (C10)

5.36. Special Condition C10 clarifies the provision of excluded services by the licensee in relation to the activities undertaken by the NTS licensee.

Transmission planning code (C11)

5.37. The Transmission Planning Code provisions set out in Special Condition C11 are intended to make NGG NTS's network planning process and methods more transparent to shippers, Ofgem and other interested parties and to allow external parties to contribute to the planning processes. Greater transparency in network planning should allow shippers to better understand the impact of auction signals on network design and thus better inform their bidding strategy which should in turn lead to a more efficient network.

5.38. In our December 2006 Final Proposals, we discussed the introduction of a new obligation on NGG NTS to conduct a wide ranging review of its forecasting and

⁵⁸ Ofgem (21 March 2007), National Grid Gas System Operator Incentives from 1 April 2007, Final proposals and statutory licence consultation (Ref. No. 43/07).

⁵⁹ Ref. No. 89/07.

⁶⁰ Ref. No. 43/07.

network planning. We subsequently consulted on the introduction of a licence obligation for NGG NTS to produce a Transmission Planning Code.

5.39. The rationale behind this new policy is to deliver greater transparency and clarity for system users and help ensure consistency, especially when faced with changing patterns of flow across the NTS network in future. We consider that it is important to allow customers to be able to provide input into the manner in which NGG NTS plans its network in response to user commitment signals and other network planning considerations. We also consider that the Transmission Planning Code should be a live document changing as appropriate. We have therefore included governance arrangements to allow for consultation to update the document.

5.40. We anticipate that the transmission planning code will provide better information about network parameters for the next price control review and will support enhancement of other policy initiatives, for example to make the interaction between gas flow patterns and capacity bookings at different nodes more transparent.

Network output measures (C13)

5.41. Special Condition C13 on network output measures is consistent with our intentions outlined in the TPCR Final Proposals⁶¹.

5.42. This condition will ensure the collection of robust data on the condition of assets. Furthermore, it brings the reporting obligations of the NTS licensee into alignment with those in place for electricity transmission.

Price control revenue reporting and associated information (C14B)

5.43. The introduction of Special Condition C14B will improve transparency of revenue information reported to the Authority, and is in line with our December 2006 Final Proposals⁶². Furthermore, this condition brings NTS revenue reporting processes into alignment with the obligations already in existence for electricity transmission and electricity distribution.

Licensee's methodology for determining incremental entry capacity volumes (C15)

5.44. Special Condition C15 contains obligations on NGG NTS to prepare and submit for approval by the Authority an incremental entry capacity release (IECR) methodology statement and to use reasonable endeavours to apply the methodology set out in that statement. The purpose of the statement is to describe the

⁶¹ Paragraphs 12.5 to 12.8.

⁶² For example, paragraphs 12.1 to 12.4.

methodology by which NGG NTS determines whether to make incremental entry capacity available for sale to gas shippers. This includes describing how NGG NTS determines, based on bidding for capacity by shippers in long term system entry capacity auctions, whether there is demand for additional firm entry capacity, and, therefore, whether it should submit an incremental obligated entry capacity proposal (or proposals) to the Authority.⁶³

5.45. We have updated Special Condition C15 in light of the new policy of entry capacity substitution, to say that where appropriate the IECR methodology should take into account the licensee's obligations with respect to this new policy. We have retained the requirement previously set out in the NTS licence for the IECR methodology statement to be accompanied by a statement from appropriate auditors giving their opinion on the extent to which the licensee has developed a methodology that is consistent with its duties. However, we have added a provision that allows this requirement to be lifted if the Authority consents otherwise. We have also made some minor housekeeping changes to Special Condition C15.

NTS performance reporting (C16)

5.46. Special Condition C16 secures the collection of information by the licensee so as to monitor the environmental performance of the NTS.

Exit code statement (C17)

5.47. Special Condition 17 is largely unchanged from the existing version of the condition. The only substantive change to the condition is to clarify that the licensee would not be required to continue to prepare the statement under the enduring offtake regime.

5.48. The principal intention of Special Condition 17 is to provide transparency as regards the services and costs relating to exit activities between the licensee and its distribution network businesses. The activities covered by the condition are defined in Special Condition C8A.

Licensee's methodology for determining the release of NTS exit capacity volumes (C18)

5.49. Special Condition C18 requires the licensee to prepare a statement setting out the methodology by which it will determine how it will release NTS exit capacity to shippers and gas distribution network businesses. In the first year of the condition the statement shall be submitted to the Authority for approval within 30 days of the condition coming into effect and by 1 April in each subsequent year. The statement should be in line with the licensee's objectives under the Gas Act and other conditions of its licence, and the Authority can ask for an Auditors opinion as to

⁶³ See paragraph 3.15.

whether this is the case. The licensee shall apply the methodology when making decisions about how to release exit capacity.

5.50. When revising the statement the licensee shall undertake a consultation process. The licensee shall publish the latest version of the statement for interested parties.

5.51. The overall intention of this condition is to provide for an appropriate methodology for the release of NTS exit capacity, and to ensure that there is transparency as to the methodology.

Network model (C24)

5.52. When we originally consulted about the network model we intended that it would provide transparency about the capability of the NTS network to shippers, Ofgem and other interested parties and to support the transfer and substitution of capacity. In the light of responses to our consultation we decided that it was not appropriate at this time to make a network model publicly available and concluded that a model should only be made available to Ofgem to inform the policy teams about the technical capability of the network.

5.53. We expect NGG NTS to develop a network model under Special Condition C24 that will provide Ofgem with the ability to model the technical capability of the NTS network, taking into account the Transmission Planning Code, to provide information to inform policy decisions.

5.54. We expect that the model will be sufficiently accurate to establish the relationship between quantities of capacity at different points on the network for various policy purposes, for example setting baselines and to provide information on network flexibility.

5.55. We consider that the model developed may ultimately be less technically accurate than the model NGG NTS would use to plan the network. We believe that it is more important that the model is capable of simulating a wide range of scenarios, including high level rules, to a reasonable degree of accuracy with a modest demand on time and expertise than to produce highly technically accurate results for a very limited number of scenarios involving considerable time and effort.

5.56. We recognise that it may still be appropriate in some circumstances to request NGG NTS to perform additional network simulation prior to us taking future policy decisions.

Promoting competition in the provision to the licensee of operating margins services (C25)

5.57. NGG owns four Liquefied Natural Gas (LNG) storage facilities. Currently, they are price controlled in their provision of services to the Transmission System Operator (TSO) and Scottish Independent Units (SIUs), but also provide storage to gas shippers through the deregulated market. Ofgem's aim is to get NGG to establish effective competition in the provision of services to the TSO, so that the LNG facilities can become fully deregulated. This is in keeping with Ofgem's aim of protecting consumers' interests through the promotion of competition where appropriate.

5.58. Special Condition C25 is the means by which Ofgem is pursuing the policy of deregulation of the provision of operating margins services to the TSO. Until competition is established, Ofgem will continue to regulate these services. We are currently consulting on the regulation of these services.⁶⁴

⁶⁴ Ofgem (3 August 2007), LNG Storage price control – Initial thoughts (Ref. No. 202/07)

Appendices

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Appendix 1 – 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.⁶⁵

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 accordingly⁶⁶.

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 them⁶⁷; and
- The interests of individuals who are disabled or chronically sick, of pensionable age, with low incomes, or residing in rural areas.⁶⁸

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:

⁶⁵ entitled “Gas Supply” and “Electricity Supply” respectively.

⁶⁶ 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.

⁶⁷ 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.

⁶⁸ The Authority may have regard to other descriptions of consumers.

-
- Promote efficiency and economy on the part of those licensed⁶⁹ 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 Regulation⁷⁰ 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.

⁶⁹ or persons authorised by exemptions to carry on any activity.

⁷⁰ Council Regulation (EC) 1/2003

Appendix 2 - Glossary

G

GWh/d

Gigawatt-hour per day

N

NGG

National Grid Gas plc

NTS

National Transmission System

S

SO

System Operation

T

TPCR

Transmission Price Control Review

TO

Transmission Owner

U

UNC

Uniform Network Code

Appendix 3 - 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:

- Does the report adequately reflect your views? If not, why not?
- Does the report offer a clear explanation as to why not all the views offered had been taken forward?
- Did the report offer a clear explanation and justification for the decision? If not, how could this information have been better presented?
- Do you have any comments about the overall tone and content of the report?
- Was the report easy to read and understand, could it have been better written?
- Please add any further comments?

1.2. Please send your comments to:

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