

Gas Distribution Price Control Review
National Grid Gas Response to the Capacity outputs incentive for GDPCR - October
Update Consultation
23 October 2007

Introduction

1. We acknowledge and support the developments that Ofgem has made to the Capacity Outputs Incentive (COI) in their letter published on 23 October 2007. The changes proposed more appropriately balance the risks and rewards between GDNs and consumers and will better achieve the objectives of Exit and Interruption reform.
2. In this response, we will first comment on the changes to the incentive mechanism that Ofgem has proposed and then comment on the level of the proposed targets.

1. Incentive Mechanisms

1.1 Interruptions

Form of Target / Mechanism

3. The change in approach, to set the target for interruptions payments to include the discounted cost of reinforcement required to support **all** interruptible customers as firm, is appropriate. As we set out in our response to the Updated Proposals, the cost of reinforcement associated with generic interruption is significantly larger than the costs associated with Network Sensitive Loads (NSLs) and it is appropriate that the total cost is reflected in the target set.
4. We note that Ofgem has not proposed to apply caps or collars to the revenue adjustment from the interruptions incentive, and whilst this exposes the GDNs to potentially greater variations in allowed revenue, we agree that on balance this is appropriate. We also agree that the 50:50 sharing factor is appropriate.

Capex reopener

5. We strongly support the change to the scope of the capex reopener to include the costs associated with reinforcement to remove the constraints associated with NSLs and to provide greater transportation or storage. As we have set out above, the cost of providing greater storage or transportation is much higher than the cost of "reinforcing out" NSLs. As a result it is appropriate that the GDNs are able to recover these costs if consumers do not tender at an

economic level. The power of the IQI should not be applied to the capital spend because the investment could not have been predicted at the time of setting the price control.

6. It should be noted that the projects that may be required may differ from those that were included in the GDNs' BPQs because the BPQs were based on providing capacity to meet the required level of firm demand forecast at the time of the PCR. This does not include loads that are currently interruptible but may decide not to tender interruption rights or may do so at an uneconomic level. As a result, if the GDNs are unable to secure economic interruption rights, other projects may need to be undertaken.
7. We agree that the GDNs must be required to demonstrate that the investment undertaken was both appropriate and efficiently incurred. However, we do not agree with the application of a £1m threshold. We acknowledge that the process to review and validate costs under a reopener does require resources and so should only be undertaken for material level of costs. As a result we propose an amendment to Ofgem's proposed materiality approach. All investment in excess of £1m should be dealt with at the time of the investment. All investment under £1m should be logged up over the price control and considered at the end of the period as part of the capex true up (although not subject to the power of the IQI). We believe that this appropriately balances the need to ensure that regulatory resources are used effectively and GDNs are not expected to bear unfunded efficiently incurred expenditure.

1.2 Flat Capacity

Form of the mechanism

8. Following clarification from Ofgem that the flat capacity volume targets proposed are going to be allocated by exit zone and multiplied by a price to set a financial target, we support the proposed approach. This will ensure that the investment is appropriately allocated between NTS and GDNs and also ensure that the GDNs make appropriate use of cheaper offtakes if they are available.

Price Determination

9. There are two prices that can be used to determine the financial target for the GDNs. First there is the indicative price provided by NTS and used by the GDNs when making capacity booking decisions, and second, the prevailing price in place when the GDNs use the capacity. Since there are two prices that can be used, there are three approaches to incorporating prices within the scheme that can be used when assessing the GDNs' performance. These are set out in table 1, below.

Target Setting	Indicative	Indicative	Prevailing
Performance level	Indicative	Prevailing	Prevailing

Table 1 – Table of combinations of pricing approaches

10. Whilst Ofgem has not set out which of the price combinations will be used, we understand that they intend to use the prevailing price for both establishing the target and determining the GDN's performance.
11. Instinctively it may seem appropriate to judge the GDN's performance against the prevailing price, because that is the price that the consumers will have to bear as a result of the GDN's decisions. However, this unfairly judges the GDN's performance with hindsight rather than based on the information that they had available at the time of making their decision.
12. GDNs make their decisions on the indicative prices set by NTS at the time of booking. If the GDNs can make use of an offtake with a lower indicative price, they should use that offtake because it should result in more efficient use of the gas infrastructure and savings to consumers. However the GDNs actions may result in greater demand at the offtake resulting in a higher prevailing price. If it is accepted that the GDN cannot forecast such changes in prices, and there is no reason to presume that they can, it is unfair to judge a GDN's performance on the prevailing price when they were responding in an economic and rational way to an indicative price signal. It is an important regulatory principle that the GDNs are judged against the information that they have available at the time when making decisions and not based on hindsight.
13. Setting the incentive target on indicatives but using prevailing prices exposes the GDNs to windfall gains or losses as a result of factors that are beyond the control, and the forecasting ability, of the GDNs. Likewise establishing the target and performance on the prevailing price also makes the GDN's incentive position more dependent upon unforeseen variations in prices between booking and utilisation than the economic performance of the GDN's own decisions.
14. We firmly believe that the GDN's should be judged against the information they had when they made their decisions and as such the indicative prices are the appropriate prices to use when setting the GDN's target and assessing their performance.

Exclusion of NSLs

15. We understand that Ofgem intend to set a target at the level of flat capacity required to support all loads as firm except NSLs. We do not believe that it is appropriate to assume that

the NSLs will always tender interruption at an economic level and consequently believe that NSLs should be included within the flat capacity targets. However we accept that this is a second order issue that can be resolved as part of the re-opener as Ofgem suggest.

Caps and Collars

- 16. The evidence of the current incentive mechanism suggests that the level of over or under performance against the proposed incentive mechanism is likely to be relatively small, not least because we have an obligation to book 1 in 20 capacity levels. However, if Ofgem set a mechanism which judges the GDN's performance based on using the indicative prices, we would accept a 15% cap and collar.
- 17. If Ofgem do not change their proposed use of prevailing prices, we would oppose the increase of the size of the caps and collars to 15% because the risk of a loss from the incentive mechanism as a result of events which are beyond the control of the GDNs would be too great.

1.3 Flex Capacity

- 18. We agree with Ofgem that either a relatively small financial incentive or appropriate regulatory oversight will be sufficient to ensure that effective use is made of flex.

1.4 Income Adjusting Events

- 19. We support Ofgem's approach to setting the IAE threshold as 0.5% of the GDN's allowed revenue.

2 Targets

2.1 Interruption Targets

- 20. We do not agree with the targets that Ofgem has included within the consultation for two of our GDNs, North West and East of England. We understand that Ofgem has based these numbers on the LTS BPQ update submitted in July. The targets should be set as in table 2, below.

GDN	£m Cost of Reinforcement (2005/6 prices)	Ofgem's proposed values
North West	71	60
East of England	100	90

Table 2 – Table of Estimated cost in £m of all interruptibles as firm (2005/6 prices)

These values are consistent with submissions made to Ofgem during the price control review.

- 21. Whilst we agree with the form of the incentive target, we do not agree with the way in which the total estimated cost of reinforcement has been converted to an annualised target because we do not believe that it appropriately reflects the decision making process that the GDNs will be undertaking.
- 22. The chart below shows the profile of return and depreciation of a notional £90m investment. In the first year the depreciation is 1/45th of the investment and the return is 4.84% of the asset valuation (based on the current modelling assumption rate of return). In the following years the depreciation stays constant but the absolute level of return reduces as the net book value of the asset declines. The line shows the level at which Ofgem has set its target.

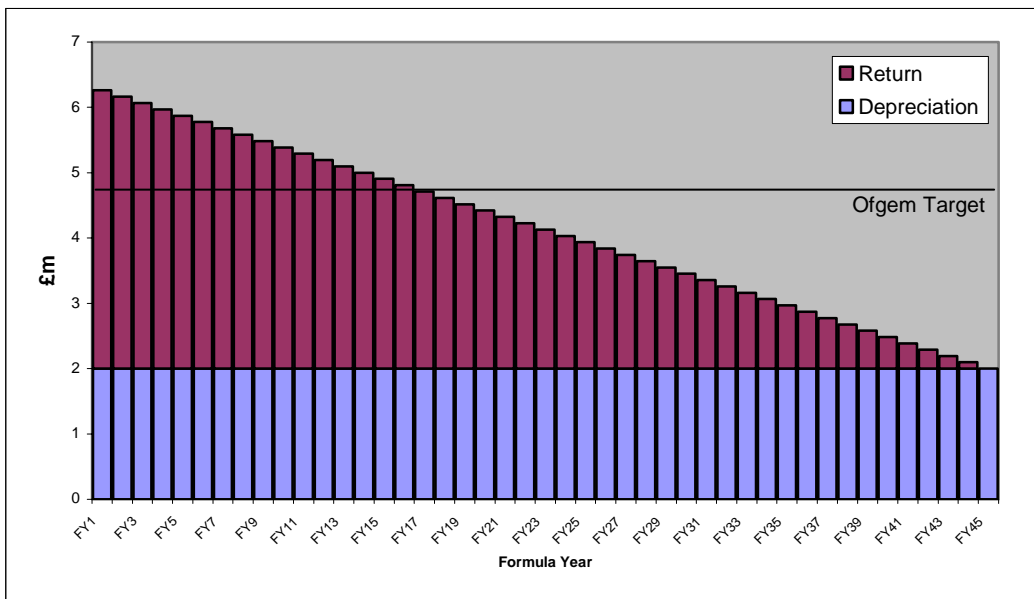


Figure 1 – Profile of return and depreciation over the regulatory life of an asset

- 23. The GDNs will buy interruption rights to defer investment and this will result in the consumers deferring the first year of payment for the asset, equivalent to the size of the first bar in the bar chart. However Ofgem’s target is below that level because it has been calculated using the discounted return over the 45 year life of the asset.
- 24. If a GDN received an interruption tender at a price between the Ofgem target and the first year cost to the consumer the GDN would be forced to reject the tender and invest. This is certain to result in the consumers incurring greater cost in the first year and potentially for the next 44 years because other consumers might have been prepared to offer “cheap” interruption in the following years, but cannot because the investment will have already been made.

25. We believe that it is appropriate that the target should be set on the basis that is most closely equivalent to the decision making process the GDNs will be making when assessing the interruptions bids. As such the annuitised cost should be calculated as 1/45th depreciation on the asset value and the return element of the full asset value in year one.
26. A further consideration when setting the interruption target is to consider the impact of inflation. Ofgem do not make it clear what price base the interruption targets in table one of appendix one are in. However we believe that they are in 2005/6 prices as this was the price basis that they were submitted in under the PCR.
27. To ensure that appropriate targets are set, Ofgem should inflate the values at the level of inflation plus real price effects applied to other capital investment in the price control, appropriate to the year to which they apply. Failure to do so will result in significantly underestimated targets and is contrary to way in which Ofgem has set the targets.

2.2 Flat Targets

28. As we have set out earlier in our response (see 1.2) the LDZ level capacity amounts need to be disaggregated into exit zone targets such that they can be converted into a financial target. We understand that Ofgem did not receive the complete data that they needed from all GDNs to allow them to undertake their analysis and consult on the exit zone level values, and so has been unable to include them in the consultation.
29. As a result, we are unable to comment directly on the targets that Ofgem is proposing. We understand that Ofgem has accepted that the capacity requirements we submitted on an exit zone level are appropriate. However we have been unable to reconcile the numbers that we submitted in SQ OP-NGG-1036 to the numbers in the consultation. We believe that Ofgem has applied a uniform rather than exit zone specific CV to convert them to Gwh targets. We believe a specific CV should be used. The targets should be revised to the values set out in table 3, below.

	2011-12 (Gwh)	2012-13 (Gwh)
NW	601.61	608.95
EA	408.48	414.16
EM	565.00	571.99
NT	517.21	522.16
WM	465.03	469.74

Table 3 – Table of Flat Capacity (Gwh) for all sites less NSLs