National Grid House
Warwick Technology Park
Gallows Hill, Warwick
CV34 6DA

National Gas Emergency Service - 0800 111 999* (24hrs)
*calls will be recorded and may be monitored

Joanna Whittington
Gas Distribution
Ofgem
9 Millbank
London
SW1P 3GE

Mark Brackley
Regulatory Frameworks Manager - Gas

Mark.brackley@uk.ngrid.com
Direct tel 01926 656024
Direct fax 01926 653042
www.nationalgrid.com

9 November 2007
Our Ref: AHT/MB/GDPCR Capacity Output Incentive response

Dear Joanna

National Grid Gas plc Transmission response to Capacity outputs incentive for GDPCR – October Update Consultation (254/07)

This is the response of National Grid Gas' transmission business (referred to in this letter as "National Grid Gas Transmission") to the above consultation. Our response is not confidential and we are happy for you to publish it. We have previously provided a response to the GDPCR Updated Proposals Document ("the Updated Proposals") which we will refer to in this letter.

We do not entirely agree with the approach outlined in your consultation letter due to a number of concerns described in more detail below. In summary, we consider that:

- the 100% sharing factors for the flat capacity incentive should be retained in order to provide an appropriate incentive to GDNs to efficiently trade off booking flat capacity on the NTS against investment on their systems;
- further analysis should be undertaken to determine an appropriate cap and collar for both the flat and interruptible incentives;
- GDNs' booking of flex capacity must be incentivised to avoid potential detrimental impacts on end consumers in terms of security of supply issues and to ensure efficient use of the NTS; and
- Development of flex capacity incentives should be postponed until further analysis requested by Ofgem has been completed.

We have structured our response in line with the paragraph numbering of your letter.

Paragraph 1
In paragraph 1 you note that the capacity outputs incentive is intended to incentivise GDNs to make efficient use of the capacity management outputs available to them and that in the absence of any specific mechanism the GDNs would have no financial incentive not to overbook it. We also consider this to be an important principle and therefore believe that incentives should be placed on GDNs to ensure that they make efficient use of the capacity management outputs available to them.

Paragraph 2
In paragraph 2 you note that you have reviewed the information from the NTS Offtake Capacity Statement process and have now produced values for the incentive parameters. We would be interested to know how the NTS OCS information has been used in the calculation of the incentive parameter values, particularly given that the OCS process in 2007 only provides firm bookings of flat and flex NTS capacity to 2010/11. Indicative bookings are agreed for 2011/12 but these will not be made firm until the 2008 OCS process. No information is provided for 2012/13 in the 2007 OCS process.

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Paragraph 6
This paragraph describes your revised proposal to determine the interruptible incentive by calculating the discounted reinforcement cost of the network investment required to support all interruptible customers as firm. We are unsure from the detail provided in the letter whether the network investment cost calculations have included any NTS network reinforcement costs. We consider that the scenario of all interruptible customers becoming firm would require an increase in bookings of NTS flat and flex capacity, as demonstrated by the marked increase in the proposed flat capacity targets being suggested within Table 2 of Appendix 1 of your letter. This could also lead to potential investment in NTS reinforcement. We would therefore appreciate clarification of the cost calculation in this area and would welcome further discussions with Ofgem on this point.

Paragraph 10
Paragraph 6.25 of the Updated Proposals suggested that 100% sharing factors for both the flat and interruption capacity incentive would promote the most efficient tradeoffs. We did not comment on this in our response to Updated Proposals as we considered it to provide an appropriate incentive to GDNs to book efficient levels of NTS capacity.

We note that in paragraph 10 of your letter you propose to amend the sharing factor for the NTS flat capacity target significantly by reducing it to 50% to keep it in line with the proposed amendment to the interruption incentive target. We do not consider this to be appropriate, as it weakens the incentive on GDNs to book NTS flat capacity efficiently.

Furthermore, paragraph 10 of your letter reiterates the intention to introduce wider caps and collars as mooted in the Updated Proposals, but with a suggestion of 15% level. In paragraph 6.25 of Updated Proposals, you proposed to set the caps and collars at 10%. We understand that you have not yet had the opportunity to review responses to the Updated Proposals in this area, so we are uncertain as to the reasoning for the significant change between the level of caps and collars proposed in September and those proposed in your October letter.

Paragraph 11
Paragraph 11 of your letter states that there was insufficient time before publication of the letter to review responses to the Updated Proposals. For ease of reference, we therefore reproduce the comments we made in our response to the Capacity Output Incentives section in Chapter 6 of the Updated Proposals.

> *“Question 4: Do you agree with our approach to the capacity outputs incentive? What are the issues raised by incentivising or not NTS flex capacity?*
>
> We do not consider the following statement in paragraph 6.31 to be accurate:
>
> *“Because NTS flex capacity is produced as a by-product of investing for flat capacity, and the NTS incurs no incremental cost in providing it, the NTS does not charge anything for its use. This means that under the transitional arrangements the NTS exit capacity charges faced by shippers are driven solely by the GDNs’ flat capacity bookings.*
>
> NTS exit capacity charges for the interim and transitional arrangements are based on forecast 1-in-20 peak flows. NTS exit flat capacity bookings by GDNs are made under the OCS process and therefore do not directly influence NTS exit capacity charges.
>
> GDNs book NTS exit flat and flex capacity under the OCS process. Once NTS has agreed to a GDN request to increase its flat or flex capacity booking, that booking will prevail until the GDN chooses to reduce its booking and NTS cannot unilaterally reduce a GDN booking of NTS exit flat or flex capacity once it is made. Historically, NTS exit flex capacity bookings would have been minimised and primarily used to support the GDNs where no other viable alternative was available, for example, where investment could not be made on the GDNs’ systems within the timeframe required. Going forward, unless GDN flex bookings are controlled via an incentives mechanism, there is a risk that GDNs preferentially book NTS exit flex capacity rather than invest in their own networks. This could lead to constraints on the NTS which could disadvantage other NTS users or other GDNs, therefore we would support incentivising GDNs’ flex bookings.”

It should be noted that, historically, provision of flexibility to the GDN was expected to be a time defined service to provide support to the GDN whilst demand growth in the GDN attained a level at which pipeline investment was efficient and economic, at which time the requirement for NTS within-day support would fall away.

You also state in paragraph 11 that you are unaware of “any new analysis on the subject of NTS flex constraints”. On 1 November 2007, Ofgem wrote to National Grid Gas Transmission (in a letter published on its website) requesting information on the availability of NTS exit flexibility capacity and proposing a six week period for the completion of such analysis. We would therefore suggest that any further work in the area of Flex capacity incentives should be postponed until the responses to the Updated Proposals can be fully analysed and the results of any analysis provided by National Grid Gas Transmission reviewed, in whichever timescales are agreed between the two parties for such tasks.

Paragraph 12
We agree with Ofgem’s summation that the removal of a flex capacity incentive on GDNs might remove the incentive to book such capacity efficiently.

We are not convinced that using other regulatory options, such as the explicit scrutiny suggested in the letter, would provide sufficient incentive on GDNs to book flex capacity in an efficient manner. The proposed 10 per cent year on year increase figure to trigger such scrutiny is also of concern, given its arbitrary nature and the implication that any increase below this threshold is acceptable and would be available from the NTS. We would argue strongly against any suggestion that the NTS is an infinite resource of such capacity.

In line with our comments on paragraph 11 above, we agree that it is not appropriate to consult on flex capacity incentive values at this stage.

Appendix One
We note that the proposed Flat Capacity figures provided in Table Two of Appendix One for 2011/12 represent an increase of 5% in aggregate over the figures provided for the same formula year in the Section 23 notice issued on 18 June 2007. The figures provided for 2012/13 represent a further 1% increase. We would be interested in the underlying rationale and assumptions for the revised figures.

Should you wish to discuss any of the issues raised in our response, please do not hesitate to contact me.

Yours sincerely

Mark Brackley
Regulatory Frameworks Manager – Gas