

Ref: AW/PW/082

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Cc: Joanna Whittington

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Dear Lewis

**Re: Capacity Output incentives and Interruption Reform**

Introduction

I am responding to your capacity outputs incentive consultation and also taking the opportunity to comment on the linked issues raised in your 25 October letter on interruption reform. We plan to submit a more detailed response to this letter separately.

We have one major concern in the consultation that we would like you to investigate. If no additional flex is available then the £48m estimated cost for all interruptibles as firm for NGN is around £10m (2005/06 prices) below NGN's requirement as set out in the 2b response to the BPQ and needs to be increased. We think this error has arisen because around £10m of NGN's expenditure on the Keighley – Calder Valley pipeline has been deferred to 2013/14 and is not included in capex allowances for 2007/08 – 2012/13. PB Power appears to have inadvertently not added this back when assessing option 2b; this expenditure would be required in 2011/12 (confirmed by PB Power) if no additional flex was available. Consequently, the estimated cost of all interruptibles as firm should be **£58m** and the incentive allowed should be **£3.2m** (2005/06 prices).

Flat capacity

You highlight in paragraph 9 that the flat capacity incentive excludes those customers currently categorised as NSLs. It is appropriate to exclude an element of NSLs but the total amount of interruptible capacity we would need to purchase on a 1 in 20 day is less than the total SOQs of the NSLs (say 80%). Furthermore, and of more concern, NGN's long term development statement, which represents the best forecast of demand and will be the driver of our NTS bookings is higher than the allowances given (even after subtracting NSLs). The required flat capacity allowances consistent with our LTDS are given below:

GWh	NO		NE	
	2011/12	2012/13	2011/12	2012/13
1 in 20 requirement	304.06	308.02	345.45	352.41
80% of NSL requirement	4.42	4.42	2.86	2.86
<b>Appropriate flat capacity incentive</b>	<b>299.64</b>	<b>303.60</b>	<b>342.59</b>	<b>349.55</b>

One of the unknowns GDNs face in assessing whether to procure NTS flat capacity is the 2011 NTS flat capacity price. GDNs require certainty in this area, therefore NGN proposes that the incentive should be based on either 2008 actual prices or published 2011 indicative prices.

NGN is comfortable with the 50/50 sharing arrangements but believes that, given the risks around the inadequate allowance, the caps and collars should continue to be set at 7½%.

#### Flex capacity

NGN's understanding is that there is little constraint on NTS flex capacity in NGN's region. Consequently our expectation is that our required flex request to meet our 1 in 20 obligation assuming only NSLs are interruptible will be met in full.

If only NSLs are interruptible from 2011/12 then NGN will need approximately 18% flex increase in NE LDZ and 60% increase (from a low base) in NO LDZ. NGN would be comfortable with the explicit scrutiny of flex bookings proposed in paragraph 12 as we only book to achieve our 1 in 20 requirement, however we are concerned that the NTS has so far not allowed any increase in indicative allowances for 2011/12 over 2010/11 despite, for example, a higher booking by NGN in 2007/08 than NTS's indicative allowance for 2011/12. As a minimum, NTS should be required to indicate how much of the required extra flexibility is available; it is not appropriate for GDNs to be simply given the value of their last firm booking.

The consultation refers to flex being potentially auctioned at zero price suggesting that Ofgem is still considering modification 116V. NGN would welcome early clarification on Ofgem's views in this area, given that implementation of 116V is still anticipated under UNC for 1 April 2008. Ofgem should note that the system issues suggest that this proposal may not at this late stage be capable of implementation on this date.

#### Interruption

NTS will only provide firm figures for 2011/12 flex in September 2008. However GDNs will have to make decisions on 2011/12 interruption in June 2008. The timetable is inconsistent as GDNs will be unable to determine how much interruption is required. The timetable for NTS to confirm flex availability should be brought forwards from October to May. Alternatively, our understanding is that the flex capacity is available in NGN's network and Ofgem should require the NTS to confirm the total amount of flex available in each LDZ for 2011/12 by June 2008.

NGN would like confirmation that the values in table 1 are at 2005/06 prices (consistent with the reports on which they are based) otherwise they are inadequate. In addition, we would like Ofgem to review the calculation as we believe the additional cost, based on PB Power's assessment methodology, should be £58m as set out in the introduction to this letter.

Arrangements need to be in place to deal with interruptions requested by the NTS. There must be some form of back-to-back arrangement so that any liabilities incurred by GDNs when the NTS calls for interruption can be passed to the NTS.

#### Interruption and the Economic Test

NGN does not agree with the comment in Lewis Hodgart's letter of 25 October that not applying the economic test (ET) to existing interruptible customers but applying it to new and incremental requests for capacity is discriminatory. It would be extremely complicated to apply the ET in an area where one reinforcement project was required but several customers are NSLs, in particular if a range of bids was received from these customers. It also appears to us

to be inappropriate to apply the ET given that Ofgem did not consider or discuss it in its March 2007 mod 90 impact assessment and does not discuss it in the incentives consultation. NSLs have had no option to date but to be interruptible and it would be inappropriate, without due consultation, to expect a contribution to reinforcement. Not applying the ET to interruptible customers does not set any precedent for future application of the ET by GDNs.

### Capex reopener

The criteria under which Ofgem grant a capex reopener should be as transparent and pre defined as possible; we discuss below three issues that need to be considered. Ofgem should put a process in place for considering reopener requests as GDNs would need clarity shortly after the June auctions each year as to whether capex would be allowed into the RAV so that an economically appropriate decision can be made on accepting interruptible bids or reinforcing the network.

### **Efficiency**

Broadly, NGN would expect that investment would be allowed (subject to marketing and materiality constraints) if the annuitised value of the investment was lower than the expected annual cost of purchasing interruption.

### **Marketing**

NGN (and each of the other GDNs) is undertaking significant promotional and marketing activity to publicise the interruption auction process. NGN will have a fully auditable tender and selection process. It would be helpful if Ofgem clarifies exactly what would encompass “effective marketing” so that we can ensure that we have passed and exceeded the threshold so that applications for capex reopeners are considered purely on their numerical applicability.

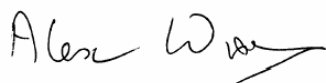
### **Materiality**

NGN suggests that £1m would be an appropriate threshold for a capex reopener which would balance the downside risk for GDNs against the time and resources utilised by GDNs and Ofgem respectively in submitting and assessing a bid.

Investments should be “logged up”, eg an investment commencing in year 1 below the materiality threshold can be combined with an investment commencing in year 2 if together they exceed the materiality threshold. Furthermore, investment allowed under the capex reopener should all be treated as “pot 3”.

I hope that you find the comments above helpful. Please don't hesitate to contact me if you require any clarification. I can confirm that this response is not confidential.

Yours sincerely



Alex Wiseman  
Regulation Director