Review of Entry Capacity Operational Buy-back Incentive and Default Incremental Entry Capacity Lead Time

Document type: Consultation

Ref: 11/09

Date of publication: 25 February 2009

Deadline for response: 25 March 2009

Target audience: NGG NTS, gas shippers, producers, storage operators, interconnectors, GDNs, other stakeholders and other interested parties

Overview:
Ofgem set the parameters for the entry capacity operational buy-back incentive and the default incremental entry capacity lead time at Transmission Price Control Review 4 (TPCR4), which relates to the 2007-2012 period. We said at the time of TPCR4 that we would review both the incentive and the default incremental entry capacity lead time after two years. This consultation document invites comments on our thoughts on these parameters. The document sets out our analysis and rationale for our preferred approach, which is to decrease the target level of the entry capacity operational buy-back incentive and to defer reviewing the default incremental entry capacity lead time until the next price control review. We invite views on these proposals.

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Context

During Transmission Price Control Review 4 (TPCR4), which relates to the 2007-2012 period, Ofgem revised the buy-back incentive by separating it into two components. One was for incremental entry capacity signalled after 31 March 2007, ie, entry capacity which is additional to the non-incremental obligated levels ("baselines") set at TPCR4 and has been backed up by user commitment. The other was for all other 'operational' entry capacity, which relates to baseline levels set at TPCR4, incremental entry capacity signalled before 1 April 2007, etc. TPCR4 also reviewed some of the parameters for the entry capacity operational buy-back incentive and set the default incremental entry capacity lead time at 42 months.

Additionally, the final TPCR4 proposals stated that we would review both the entry capacity operational buy-back incentive and default incremental entry capacity lead time after two years. Ofgem's Corporate Strategy and Plan for 2008-2013 also stated that we would review the entry capacity buy-back incentives.

In May 2008 the baseline re-consultation concluded that baselines should be increased slightly at a number of entry points and that the target level for the entry capacity operational buy-back costs should increase to £21 million.

This document invites comments on the findings from our review of the entry capacity operational buy-back incentive parameters and gives our reasoning for our preferred option, which is to decrease the target to £13 million. It also sets out our reasoning for deferral of the review on the default incremental entry capacity lead time until the next transmission price control.

We expect to publish our final decision in March 2009 with a view to making any licence changes effective from 1 April 2009.

Associated Documents

- Modification of gas transporter licence under Section 23 of the Gas Act 1986, 30 June 2008 (Ref No. 90/08)
- Notice under Section 23 of the Gas Act 1986, 30 May 2008 (ref No. 72/08)
- TPCR gas entry baseline review - final proposals, 30 May 2008 (Ref No. 72/08)
- TPCR gas entry baseline review - impact assessment, 20 March 2008 (Ref No. 28/08)
- TPCR gas entry baseline review - baseline proposals document, 20 December 2007 (Ref No. 299/07)
- Transmission Price Control Review - gas entry baseline re-consultation, 3 October 2007 (Ref No. 234/07)
- Decision to modify the gas transport licence under Section 23 of the Gas Act 1986, 5 September 2007 (Ref No. 217a/07)
- Section 38A Notice in respect of reasons for the decision to modify the licence of National Grid Gas plc, 5 September 2007 (Ref No. 217b/07)
- Schedule to decision to modify the gas transport licence under Section 23 of the Gas Act 1986, 5 September 2007 (Ref No. 217c/07)

- TPCR 2007-2012 Final Proposals, 4 December 2006 (Ref No. 206/06)
- TPCR 2007-2012 Final Proposals, Appendices, 4 December 2006 (Ref No. 206/06b)
- TPCR 2007-2012 Updated Proposals, 25 September 2006 (Ref No. 170/06)
- TPCR 2007-2012 Updated Proposals, Appendices, 25 September 2006 (Ref No. 170/06a)
- TPCR 2007-2012 Initial Proposals, 26 June 2006 (Ref No. 104/06)
- TPCR 2007-2012 Initial Proposals, Appendices, 26 June 2006 (Ref No. 104b/06)
- TPCR 2007-2012 Third Consultation, 30 March 2006 (Ref No. 51/06)
- TPCR 2007-2012 Third Consultation, Appendices, 30 March 2006 (Ref No. 51b/06)

- Copies of these can be found on the Ofgem website (www.ofgem.gov.uk).

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Summary

Entry capacity operational buy-back incentive

The entry capacity operational buy-back incentive allows National Grid Gas (NGG) to increase its System Operator (SO) revenue if it can contain the costs of buy-back of entry capacity (other than incremental entry capacity signalled after 31 March 2007). However, if NGG incurs high entry capacity buy-back costs then, other things being equal, the entry capacity operational buy-back incentive effectively reduces its SO revenue.

The actual amounts that NGG earns from the incentive are determined by how NGG performs against a defined performance measure. The performance measure is calculated from the costs of entry capacity buy-back less revenues from the sale of certain entry capacity products, amongst other things. If NGG's performance matches the target level for the incentive it does not earn any revenue from the incentive. If NGG outperforms the incentive then it earns 50% of the difference between the target and the value of the performance measure, subject to a limit. If NGG underperforms the incentive then its revenue is effectively decreased by 50% of the difference between the target and the value of the performance measure, subject to a limit.

At the time of the last Transmission Price Control Review (TPCR4) Ofgem changed NGG's entry capacity buy-back incentive which applied to both incremental and existing entry capacity. There were two main changes: first, the existing single incentive was split into two separate incentives (one for incremental entry capacity signalled after 31 March 2007 and another for all other 'operational' entry capacity) and second, some of the incentive parameters were changed. In the final TPCR4 proposals we decided not to make the extensive changes that we had suggested in earlier price control consultation documents. This was because there was some uncertainty regarding future buy-back prices and volumes. We decided to review and potentially reset the parameters of the incentive after two years.

In May 2008 we concluded our review of non-incremental obligated entry capacity ("baselines") which resulted in a slight increase in baseline levels at a number of entry points with a consequential increase in the entry capacity operational buy-back incentive target from £18 million to £21 million. In making this decision we were mindful of the need to preserve the integrity of the TPCR settlement and, in particular, the need to leave the settlement intact pending the completion of the buy-back review. As a consequence, during our review of baselines, we did not use information on actual and estimated buy-back costs which would not have been available to us at the time of TPCR4.

In our review of the incentive parameters we have considered four different options: changing the cap and collar, changing the sharing factor, changing the target, or making no change to the parameters set at TPCR4 and subsequently amended at the time of the baseline review.

At this point in time, our preferred option is to reduce the target level of the incentive to a figure in the range of £12.4 million to £13 million (from its current level of £21 million). This is because:

- buy-back costs in 2008/9 were estimated to be between £12.4 million to £13 million in late 2007 and early 2008 and are expected to fall by 2011/12 (although the figures for 2011/12 are necessarily less certain)
- our view that NGG has a history of outperforming this incentive, and
- our view that NGG would not be significantly financially disadvantaged by tightening the buy-back incentive. We consider that a target level of in this range is one that still allows NGG to earn sufficient revenue to incentivise it to contain buy-back costs.

NGG has informed us that it is not clear as to what has changed since the TPCR4 when the entry capacity operational buy-back incentive scheme was initially agreed, or since June 2008 when the scheme target was last adjusted, that would suggest the need to re-open the incentive parameters going forward. On this basis NGG does not believe changes to the incentive scheme parameters are necessary. It has also stated that it considered regulatory certainty as being vitally important to avoid undermining the effectiveness of the incentives. We invite views on our analysis of the various options and on our preferred option to reduce the target level.

Default incremental entry capacity lead times

The default incremental entry capacity lead time is the time between when an auction signal is received and when NGG is contractually obligated to deliver the relevant capacity. At TPCR4 we set the default incremental entry capacity lead times to 42 months. NGG had argued during TPCR4 for a 48 month default incremental entry capacity lead time period. However, we were not persuaded by the evidence that NGG presented at that time and therefore stated our intention to review the default incremental entry capacity lead times at the same time as the entry capacity operational buy-back incentive. Since TPCR4 there have been only two incremental entry capacity signals. We consider that this is insufficient information on which to base a review of the default incremental entry capacity lead times and so propose deferring reviewing this until the next transmission price control review. Again, we invite views on our proposal to defer reviewing the default incremental entry capacity lead times.

Timeline and way forward

We welcome views on all aspects of the review of entry capacity operational buy-back incentive and default incremental entry capacity lead times. The consultation will close on 25 March 2009. We do not intend to provide another round of consultation before reaching our final decision. Where, in this document, we refer to Ofgem's views these are provisional views and are subject to further consideration of any points raised in this consultation process. Responses to this consultation will be carefully considered before we decide on the appropriate parameters for the entry capacity operational buy-back incentive. We would envisage a decision document in April 2009 along with a Section 23 notice, should that be required, to change NGG's gas transporter licence. Our preferred approach would be to implement any such changes retrospectively from 1 April 2009 as this is the start of the formula year; however, this is subject to views received from the consultation.

1. Introduction

Chapter Summary

This chapter sets out why we are reviewing both the entry capacity operational buy-back incentive scheme and the default lead time for incremental entry capacity.

It also gives a brief description of what is contained in each of the main chapters.

Purpose of this document

1.1. In our final proposals for the Fourth Transmission Price Control Review (TPCR4), which covered the period 2007-2012, we said we would review two issues after two years. These involved entry capacity operational buy-back and default incremental entry capacity lead times.

1.2. The entry capacity operational buy-back incentive allows National Grid Gas (NGG) to increase its System Operator (SO) revenue if it can contain the costs of buy-back of entry capacity (other than incremental entry capacity signalled after 31 March 2007).

1.3. In the earlier TPCR4 consultations we had originally signalled an intention to make extensive changes to the entry capacity operational buy-back incentive parameters. However, by the time of final proposals, we considered that there was uncertainty surrounding future buy-back prices and the volumes and scope for NGG to sell capacity over and above baseline. Therefore, we decided not to make extensive changes to the incentive scheme parameters but to review and potentially reset the parameters after two years. NGG's gas transporter licence (the "Licence") allows it to reject this review[1], should it wish, by allowing it to provide a notice to the Authority to set the value of the revenue earned from the entry capacity operational buy-back incentive to zero.

1.4. In setting the default incremental entry capacity lead times at TPCR4 NGG contended that all future releases of incremental entry capacity (with one possible exception) would take 48 months to deliver, despite its past performance indicating otherwise. Ofgem stated that it was not persuaded by the evidence NGG had presented and set the default incremental entry capacity lead times at 42 months. However, Ofgem stated that it also intended to conduct a review of the default lead time for incremental entry capacity.

[1] As set out in Special Conditions C8D(3)(j) to C8D(3)(m) of the Licence.

1.5. This document sets out our review of the entry capacity operational buy-back incentive and also our view that the review of the default lead time for incremental entry capacity should be deferred until TPCR5.

Overview of this document

1.6. This document is organised into the following chapters:

- Background - explains some background to the operation and use of the UK gas transmission system along with how NGG earns revenue in its role as system operator, including the specifics of how it can earn revenue from the entry capacity operational buy-back incentive. It also provides a summary of the changes to the incentive scheme arising from the baseline review and sets out NGG's initial view.
- Entry capacity operational buy-back review - this sets out the different options for reviewing the incentive and our preferred option.
- Review of default incremental entry capacity lead times - this sets out our rationale for deferring the review of default incremental entry capacity lead times until the next transmission price control

Other SO Incentives

1.7. In addition to this consultation on the entry capacity operational buy-back incentive there is ongoing work on other NGG System Operator (SO) incentives which expire in March 2009. These other incentives also impact on the amount of SO revenue that NGG earns. This work is not in the scope of this consultation as this focuses on reviewing and potentially resetting the entry capacity operational buy-back incentive parameters. In terms of this ongoing work on the other SO incentives NGG has recently consulted on its initial proposals for an incentive scheme in respect of its incentivised external SO costs[2]. Ofgem is expecting to publish final proposals for these incentives by the end of February 2009 with a view to implementing the new incentive scheme for 1 April 2009[3].

[2] See 'National Grid Gas (NGG) SO Incentives for 1 April 2009: Initial Proposals Consultation', 12 November 2008 on NGG NTS's website www.nationalgrid.com/uk/gas/
[3] NGG's current incentive scheme for these external SO costs which are current being consulted on, is due to expire on 31 March 2009.

2. Background

Chapter Summary

This chapter gives some background to the issues in the consultation. This includes a summary of the operation and usage of the gas transmission system in the UK, the National Transmission System (NTS), and explains how if National Grid Gas (NGG) expects that it cannot meet its obligations for sold entry capacity it may have to buy some of this capacity back from NTS users.

We describe how the maximum allowed revenue is calculated for NGG in its role as System Operator (SO) and how this is contributed to by NGG's performance regarding the entry capacity operational buy-back incentive. It also explains that in addition to the minimum and maximum amounts that NGG can earn and lose from the incentive there is also an aggregate maximum financial penalty that NGG can incur through all of the buy-back incentives.

The chapter describes the changes made to the incentive arising from the review of baselines in 2008.

It also sets out NGG's initial view of the entry capacity operational buy-back incentive and how it should be reviewed. NGG does not see any need to change the current incentive parameters.

Background

2.1. NGG owns and operates the high pressure gas transmission network in the UK, the National Transmission System (NTS). Shippers bring gas from gas fields or as imports via interconnectors and Liquefied Natural Gas (LNG) import terminals or from storage onto the NTS. The gas can then be delivered direct to Transmission Connected Customers (TCCs) or for further delivery across the low pressure Gas Distribution Networks (GDNs) and Independent Gas Transporters (IGTs) to final consumers, for export via interconnectors or to put into storage.

2.2. In order to use the NTS, shippers must first buy entry capacity, to flow gas onto the NTS, and also exit capacity, to take gas off the NTS. If shippers do not buy sufficient capacity for the actual amounts of gas they flow, they will incur overrun charges, as set out in the Uniform Network Code[4]. NGG is obligated to offer for sale certain amounts of firm non-incremental entry capacity at each entry point, called 'baselines'. It does this through long-term, medium-term and short-term auctions. In the long-term auctions if there is a sufficient user-commitment signal for capacity (in

[4] A copy of the UNC can be found on the website of the Joint Office of Gas Transporters i.e. http://www.gasgovernance.com/

addition to the baseline, and any previous signals for incremental entry capacity, at a particular entry point) then NGG can release capacity in addition to the baseline (and any previous amounts of incremental entry capacity) i.e. incremental entry capacity.

2.3. NGG in operating the NTS may find itself in a position where it expects it cannot deliver the firm entry capacity that it has previously sold at the various auctions, for example when there are temporary physical constraints on the NTS. In this situation it may buy some of the capacity back that it has previously sold in order to meet its obligations.

NTS System Operator (SO) revenue

2.4. NGG in its role as System Operator (SO) is allowed a maximum amount of revenue that it can recover each year, the calculation for which is set out in Special Condition C8C(3)(a) of the Licence. This includes a number of elements including: entry incentive revenue and costs; exit incentive revenue and costs; other external incentive revenue and costs; and the over or under recovery amount from the previous year. NGG can therefore increase or decrease its SO allowed maximum revenue through its performance against a number of incentives.

2.5. One set of incentives have been designed with the aim of rewarding NGG for containing its costs of buying back entry capacity. There are three such entry capacity buy-back incentives in the Licence which can influence NGG's SO allowed maximum revenue, these are:

- Entry capacity incremental buy-back incentive[5] – this incentive aims to reduce NGG's expenditure on buying back funded incremental entry capacity (i.e. capacity in addition to baseline) signalled after 31 March 2007.
- Milford Haven entry capacity buy-back incentive[6] – this incentive aimed to reduce NGG's expenditure on buy-back of up to 650 GWh/day of incremental entry capacity at the entry point of Milford Haven in 2007/8 and 2008/9 which was bought during the September 2004 and December 2004 long-term auctions. This was a temporary incentive which ended on 7 December 2008.
- Entry capacity operational buy-back incentive[7] – this incentive aims to reduce NGG's expenditure on buying back all other entry capacity, whilst also incentivising other behaviour. At the time of TPCR4 we considered that this incentive was subject to uncertainty and we said that we would review the incentive after two years. <u>This incentive is the focus of this consultation.</u>

[5] This is set out in Special condition C8D(5) of the Licence.
[6] This is set out in Special condition C8D(4) of the Licence.
[7] This is set out in Special condition C8D(3) of the Licence.

NTS entry capacity operational buy-back incentive

2.6. The maximum revenue that NGG can earn from the entry capacity operational buy-back incentive is comprised of the sum of the following three elements, these are:

- Total Capacity Constraint Management Costs – these are the costs incurred by NGG in buying entry capacity back which it has sold and which is not covered by the incremental and Milford Haven incentives. This element allows NGG to recover the actual costs of buying capacity back in its role as system operator.
- Revenue from accelerated release of incremental obligated entry capacity – this is the revenue that NGG earns from selling incremental entry capacity at an earlier date than the standard default incremental entry capacity lead time of 42 months.
- Incentive Revenue[8] – this is the amount that NGG can earn from the incentive it faces to contain the costs of entry capacity operational buy-back. This is described in greater detail below. <u>This revenue item in the incentive is the main focus of this consultation.</u>

2.7. NGG is allowed to recover all the costs it incurs in buying back operational entry capacity. However, through the Incentive Revenue component of the maximum revenue that NGG can earn from the entry capacity operational buy-back incentive, described in paragraph , NGG is incentivised to contain the costs of these buy-backs. If excessive buy-back costs are incurred NGG will bear a cost whereas if NGG manages to contain buy-back costs then it will earn additional revenue. This incentive is explained in more detail in the next section.

Incentive revenue

2.8. The amount of revenue that NGG can earn under the incentive mechanism is dependent on two things. First, NGG's performance in relation to buy-back costs. Second, NGG's ability to increase sales revenue from certain capacity products (including non-obligated entry capacity, interruptible entry capacity and on-the-day sales of entry capacity), amongst other things. These items are captured in a performance measure described in Special Condition C8D(3)(b) of the Licence and set out in Appendix 2.

2.9. If the performance measure is less than or equal to the target which has been set then the amount of Incentive Revenue that NGG can earn is calculated as follows (amounts are adjusted for inflation):

[8] We call this item "Incentive Revenue" throughout this document since Special Condition C8D(3)(a) of the Licence does not give it a specific name but simply the term $EnCOBBIR_t$.

Minimum [Sharing factor x (target – performance measure), upside cap]

2.10. The sharing factor determines the way in which consequences of under- and over-performance are split between NGG and shippers (and hence ultimately, consumers). This figure is currently 50%.

2.11. The target is the value of the performance measure at which the Incentive Revenue is zero. This was £18 million in 2007/8 rising to £20.25 million in 2008/9 and then is set to rise again to £21 million in 2009/10. It had an interim target value of £20.25 million in 2008/9 since the Licence was changed as a result of the decision on the baseline review[9] in the middle of the formula year 2008/9.

2.12. The upside cap is the maximum amount of revenue that can be earned by NGG through this incentive scheme. It is currently £18 million and did not change as a result of the baseline review. Applying these figures to the formula gives the following equation:

Minimum [50% x (£21m – performance measure), £18m]

2.13. If the performance measure is greater than the target level then the Incentive Revenue that NGG earns is calculated as follows (again all amounts are adjusted for inflation):

Maximum [Sharing factor x (target – performance measure), downside collar]

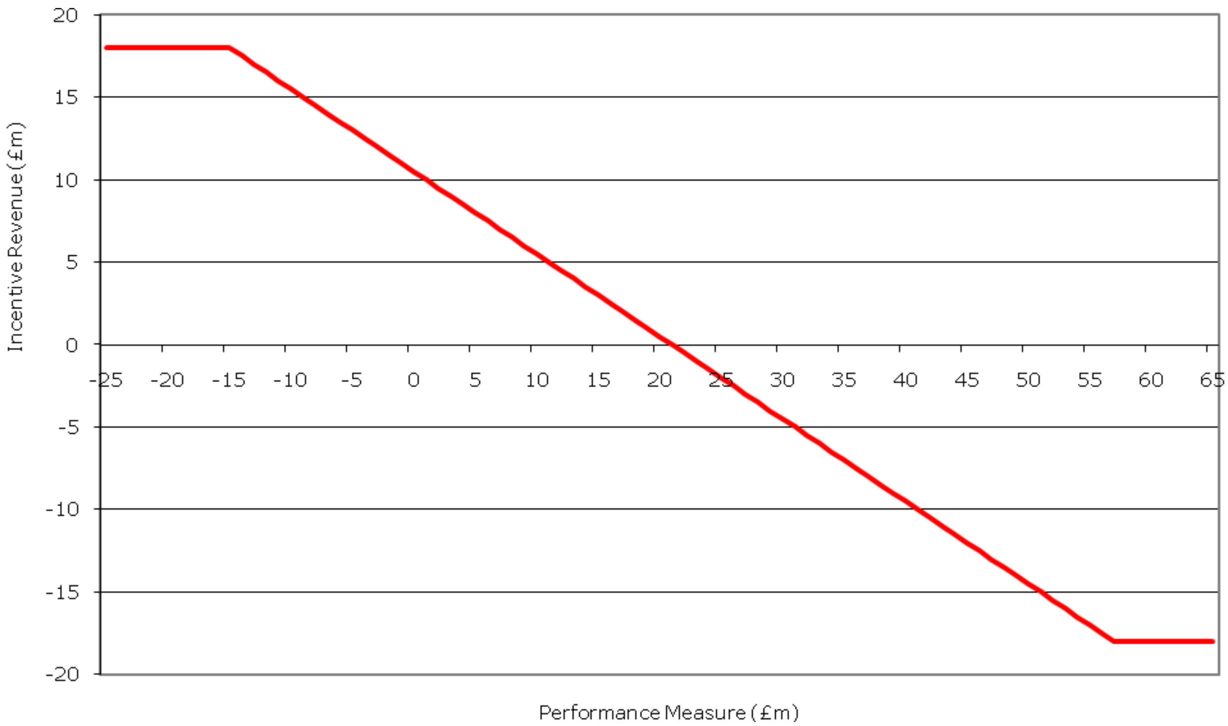
2.14. The downside collar is the limit of reduced revenues that NGG can be penalised with through this incentive. It is currently -£18 million i.e. the most that NGG's total SO revenue can be reduced from the incentive is £18 million. This equates to:

Maximum [50% x (£21m – performance measure), -£18m]

2.15. This creates a relationship between the performance measure and the Incentive Revenue as shown in Figure 1. This shows that in order for NGG to maximise the revenue earned from the incentive, i.e. at the cap of £18 million, NGG has to reduce the performance measure to -£15 million. NGG can do this by reducing buy-back costs and increasing sales revenues of certain entry capacity products, amongst other things.

[9] See our decision document 'TPCR gas entry baseline review - final proposals, 30 May 2008 (Ref No. 72/08)' and the notice to change the Licence 'Notice under Section 23 of the Gas Act 1986, 30 May 2008 (ref No. 72/08)', both of which are on Ofgem's website www.ofgem.gov.uk.

Figure : Entry capacity operational buy-back incentive revenue



Aggregate cap on buy-back incentives

2.16. In addition to the mechanism described above, there are restrictions on the total impact of the buy-back incentives. In particular, there is a cap on the amount of aggregate losses that NGG can incur from the combination of the three different buy-back incentives[10]. The aggregate total revenues from the relevant incentives are not permitted to result in losses greater than £48 million in any one year to NGG, the incentives covered by this aggregate cap are:

- Incentive Revenue (minimum of -£18m)
- Incremental entry capacity buy-back incentive revenue (minimum of -£36m in any one year subject to a monthly limit of -£4m)
- Exit capacity buy-back and interruptions incentive revenue (minimum of -£2m, prior to 1 October 2008 this was a minimum of -£7m)[11]

[10] See Special Condition C8C(3)(a) of the Licence.
[11] We are currently consulting on a change to the Licence which would remove the inclusion of the exit capacity buy-back and interruptions incentive revenue from the aggregate cap on buy-back incentives and replace it with the figure for the cap on incremental exit investment buy-back exposure as defined in the Licence by term ExXSIBBCt in Special Condition C8E(1)(g).

Baseline review

2.17. On 30 May 2008 Ofgem published its decision[12] on its review of entry capacity baselines. This decision revised the entry capacity baselines at a number of entry points upwards by small amounts. The capex and the entry capacity operational buy-back incentives were two options considered to adjust the allowances and incentives resulting from the increase in overall baselines in order to maintain the integrity of TPCR4 in terms of the risks on NGG. It was considered that the entry capacity operational buy-back incentive alone offered a better solution as it would not require a change to capex allowances. Changing capex would also have required a change in the entry capacity operational buy-back incentive given NGG's incremental entry capacity lead times.

2.18. In concluding the review and reaching a decision on baselines for the remainder of the current price control period, we decided to increase the entry capacity operational buy-back incentive target from £18 million to £21 million, as we considered it appropriate to increase the buy-back target in order to be consistent with the aim of preserving the TPCR4 settlement. The new baselines were effective from 1 July 2008 and the buy-back incentive target for 2008/9 was set at £20.25m, the adjustment being made on a pro rata basis for this formula year.

NGG's view

2.19. Prior to this consultation, we gave NGG the opportunity to give its initial views on the entry capacity operational buy-back incentive parameters and how they may be reviewed. NGG said that at TPCR4 it had accepted the target, cap and collar levels of £18m along with the level of entry capacity baselines as set. Furthermore, it accepted the increase in baselines and increase in the entry capacity operational buy-back target in June 2008 as part of the entry capacity baselines review.

2.20. NGG is not clear as to what has changed since the TPCR4 when the entry capacity operational buy-back incentive scheme was initially agreed, or since June 2008 when the scheme target was last adjusted, that would suggest the need to re-open the incentive parameters going forward. On this basis NGG does not believe changes to the incentive scheme parameters are necessary. It also stated that it considered regulatory certainty as being vitally important to avoid undermining the effectiveness of incentives.

[12] See 'TPCR gas entry baseline review - final proposals, 30 May 2008 (Ref No. 72/08)' on Ofgem website www.ofgem.gov.uk.

Ofgem's view

2.21. We note that NGG accepted the TPCR4 package on the basis of the entry capacity operational buy-back incentive parameters and baselines as set in 2007 and the revisions to these resulting from the baseline review in June 2008. However, as part of TPCR4 we stated our intention in the final proposals to review and potentially re-set the parameters of the incentive in 2009, which NGG accepted. Furthermore, new information has been made available which we consider in the interests of consistency cannot be ignored. We do not consider that this review is inconsistent with our previous statements or that it undermines the incentive regime.

3. Entry capacity operational buy-back review

Chapter Summary

This chapter sets out Ofgem's review of the entry capacity operational buy-back incentive and sets out a number of options, including our preferred option which is to reduce the target level of the incentive from £21 million to £13 million.

Questions

Question 1: Do you agree with the assessment we have set out for Option 1 - changing the cap and collar of the incentive?

Question 2: Do you have any views on lowering the incentive collar to better protect consumers?

Question 3: Do you agree with the assessment we have set out for Option 2 - changing the sharing factor of the incentive?

Question 4: Do you agree with our analysis of NGG's historic performance regarding the incentive?

Question 5: Do you agree with the analysis of the estimated future buy-back risk? Specifically, do you agree with NGG's application of a lognormal assumption for the distribution of buy-back costs? Do you agree with the use of historic buy-back prices in estimating future buy-back risk?

Question 6: Do you consider it appropriate to use the analysis done at the baseline review as part of forming our decision on reviewing the entry capacity operational buy-back incentive?

Question 7: Do you agree with our view that an entry capacity operational buy-back incentive target of £13 million per year will still provide NGG with sufficient incentives to contain the costs of buy-back?

Question 8: Do you consider that a £13 million entry capacity operational buy-back incentive target is appropriate given NGG's return on equity performance?

Question 9: Do you agree with our provisional view to reduce the target level of the entry capacity operational buy-back incentive to £13 million per year?

Question 10: Do you agree with the assessment we have set out for Option 4 - doing nothing and keeping the incentive in its current form?

Question 11: Do you agree with our proposed approach of retrospectively modifying NGG's gas transporter licence by implementing the proposed changes to the entry capacity operational buy-back incentive parameters as of 1 April 2009?

Question 12: Are there any other considerations which we have not highlighted which we should have taken into account?

Options for the buy-back incentive

3.1. In this section we consider various options to change the buy-back incentive in order to better protect the interest of consumers. In approaching this review of the entry capacity operational buy-back incentive we have considered four broad options to better protect consumers. We list them below and consider each of these in turn:

- Option 1: Change the cap and collar
- Option 2: Change the sharing factor
- Option 3: Change the target
- Option 4: Do nothing

3.2. As our intention in the final proposals of TPCR4 was to review and potentially reset the parameters of the entry capacity operational buy-back incentive we consider that changing the structure of the incentive would be outside the scope of this review. We do not consider it appropriate to change the structure of the incentive at this time and so have not included it as an option.

Option 1: Change cap and collar

3.3. One potential option is to change the upside cap, currently £18 million, and/or the downside collar, from its current level of effectively -£18 million. This could be used to sharpen the incentives on NGG to further outperform the target, providing protection to consumers.

3.4. Currently, if NGG's performance crosses the lower collar of £18 million then NGG no longer has an incentive to constrain its buy-back costs. After this point buy-back costs are passed on to shippers and ultimately consumers. Therefore, lowering the collar could potentially provide enhanced protection to consumers.

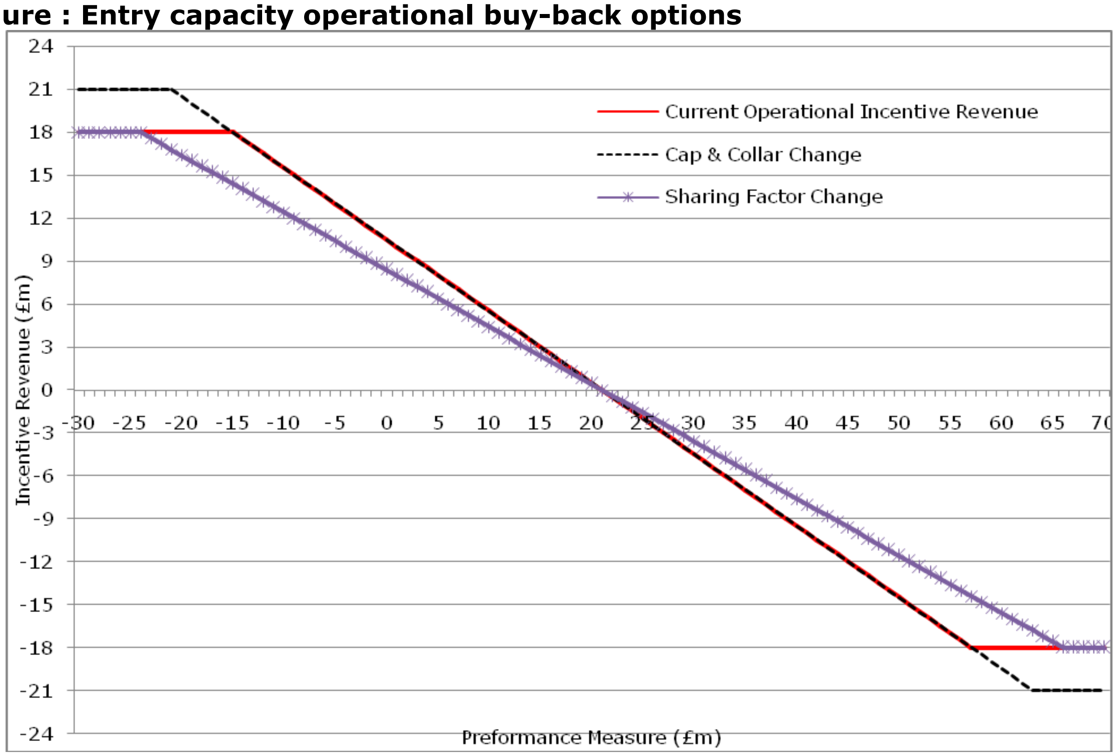
3.5. However, changing the cap and collar would only change the extremes of the performance measure (see figure 2). As NGG has not reached such extremes in its actual performance over the last six years, this would be unlikely to have much impact on NGG's operations. It therefore may not be the best targeted change to the incentive at this point in time. This is a provisional view and is subject to consideration of any points raised in response to this consultation.

Option 2: Change sharing factor

3.6. Another option would be to change the sharing factor. A reduction in the sharing factor would result in NGG obtaining less Incentive Revenue from reducing operational buy-back costs whilst shippers, and therefore consumers, would benefit more. However, the converse is that if operational buy-back costs increased then NGG would face less reduction in its revenues whilst shippers and consumers would face higher costs.

3.7. Evidence presented below, under Option 3, shows that in our view NGG have on average outperformed the target with ease. If this average outperformance continues then reducing the sharing factor could result in NGG earning less Incentive Revenue, and therefore consumers benefiting more. However, as the impact of reducing the sharing factor increases the further NGG's performance measure is from the target, then it may be more effective to protect consumers by considering lowering the target. A lower target level would reduce NGG's Incentive Revenue earned by a fixed amount across the range of the performance measures and not just by greater amounts at the extremes. A reduced target would also not result in the downside risk consumers would face from a lower sharing factor should NGG underperform against the target. We therefore do not consider that changing the sharing factor is an appropriate option to consider at this time. This is a provisional view and is subject to consideration of any points raised in response to this consultation.

Figure : Entry capacity operational buy-back options



Option 3: Change target

3.8. The third option would be to reduce the target from the current level, £21 million. A lower target would reduce the amount of Incentive Revenue that NGG would earn for each level of performance which could potentially better protect consumers. In considering the merits of such a change we have focused on NGG's actual performance along with estimates of its future exposure to buy-back costs.

NGG's actual performance

3.9. Table 1 summarises NGG's performance under the incentive mechanism from 2002/3 to 2007/8. In all but one of the years, NGG has managed to earn additional revenue based on its performance. It has earned on average £8.8 million over these years. These average earnings are set against the possible range of -£18 to £18 million that NGG can earn from this incentive. The ease with which NGG, in our view, outperforms the target suggests it could be reduced to better protect consumers.

Table : NGG entry capacity operational buy-back performance

Year	Performance Measure (£)	Incentive Revenue (£)
2002/3[13]	13,226,011	10,886,995
2003/4[14]	-2,006,991	6,003,496
2004/5[15]	-13,927,015	15,963,507
2005/6[16]	-3,310,026	10,655,013
2006/7[17]	24,374,864	-2,231,202
2007/8[18]	-3,489,269	11,629,635
2008/9[19]	-5,755,215	13,002,607
TOTAL (Excluding 2008/9)		**52,907,443**
SUB-TOTAL (years after TPCR4)		**24,632242**
AVERAGE (Excluding 2008/9)		**8,817,907**
AVERAGE (Including 2008/9)		**9,415,722**

Estimated future buy-back cost

3.10. Estimated future buy-back costs were analysed as part of our decision on baselines. However, during the baseline review we did not draw upon this analysis as we did not consider it appropriate to use information that had become available since TPCR4. However, we do consider it appropriate to use this information to help inform the outcome of this review.

[13] Upside Cap £30 million, upside sharing factor 50%, downside sharing factor 35%, downside collar -£12.5 million, upside target £35 million, downside target £35 million.
[14] Upside Cap £30 million, upside sharing factor 50%, downside sharing factor 35%, downside collar -£12.5 million, upside target £10 million, downside target £20 million.
[15] Upside Cap £30 million, upside sharing factor 50%, downside sharing factor 35%, downside collar -£12.5 million, upside target £18 million, downside target £18 million.
[16] The same parameters as in footnote .
[17] The same parameters as in footnote .
[18] Upside Cap £18 million, unified sharing factor 50%, downside collar -£18 million, unified target £18 million.
[19] This is for the period up to December 2008 for all activities except for the revenues from non-obligated capacity which include some amounts of sales of non-obligated entry capacity up to and including March 2009. The calculation of the Incentive Revenue assumes no further changes in the performance measure. In calculating the Incentive Revenue the Upside Cap is £18 million, unified sharing factor 50%, downside collar -£18 million, unified target £20.25 million.

December 2007 baseline review consultation

3.11. We asked NGG in late 2007 to re-forecast potential buy-back costs. NGG forecast the costs of buy-back for 2008/9 to be £21 million. This section describes NGG's analysis in more detail and provides our critique of this figure which suggested it may be based on extreme conditions and that a figure in the range of £12.4 million to £13 million may be more appropriate.

3.12. In our December 2007 consultation[20] on baselines we set out four different baseline options, these were:

- Option 1 - retain baselines implemented by TPCR4
- Option 1a - retain baselines implemented by TPCR4 , however for those entry points whose baseline would be below the 2002-2007 baseline figure and below NGG's forecast maximum supply figure then an upwards adjustment is made to set the baseline at the lower of the 2002-2007 baseline figure or NGG's forecast maximum supply figure
- Option 2 - introduce 'free increment' allocation based on the 2005 Ten Year Statement (TYS) flows to increase baselines
- Option 2a - introduce 'free increment' allocation based on the 2005 TYS flows to increase baselines, however for those entry points whose baseline would be below the 2002-2007 baseline figure and below NGG's forecast maximum supply figure then an upwards adjustment is made to set the baseline at the lower of the 2002-2007 baseline figure or NGG's forecast maximum supply figure

3.13. We asked NGG to forecast the potential buy-back costs in 2008/9 for each of the four baseline options being considered. For the purposes of this review we only consider the analysis done for the option which was finally implemented i.e. Option 1a[21]. NGG estimated the buy-back costs by calculating the number of days that constraints may occur using both an average and a severe (cold year) Load Duration Curve (LDC). NGG used results from its network analysis conducted at three different demand levels of:

- Peak: 580 mscm/day (6,283 GWh/day)
- One day from peak demand on LDC (D1A): 520 mscm/day (5,633 GWh/day), and
- 50 days from peak demand on LDC (D50A): 400 mscm/day (4,333 GWh/day)

3.14. Based on the network analysis NGG identified zonal constraints at the various demand levels outlined above. NGG then multiplied the constraint size by the

[20] See ' TPCR gas entry baseline review - baseline proposals document, 20 December 2007 (Ref No. 299/07)' on Ofgem website www.ofgem.gov.uk

[21] Option 1a increased the baseline slightly at a number of entry points including Isle of Grain, Teesside, Hatfield Moor (Storage), Hornsea, Glenmavis, Partington and Dynevor Arms.

number of days it would be expected to occur in order to calculate the constraint volume. The network used in the modelling included projects that were either operational or planned for 2008/9 and assumed that gas might be flowing up to the proposed baseline levels.

3.15. NGG then multiplied the constraint volumes for average and severe years by three different assumptions on the buy-back price to obtain the annual buy-back cost, these price assumptions were:

- 0.25 p/kWh/day – the weighted average price of buy-backs up to July 2006
- 0.64 p/kWh/day – the weighted average price of buy-backs up to that point in time
- 1.1 p/kWh/day – the weighted average price experienced during July 2006

3.16. NGG used the costs associated with the 1.1 p/kWh/day buy-back price and applied a lognormal assumption of buy-back costs to the severe LDC to represent the upper 95% confidence interval level value (i.e. costs would be either equal to or lower than that 95% of the time). It then calculated the expected value of the distribution. This gave an expected buy-back cost of £21 million, an increase of £3 million on the target at that time.

3.17. Ofgem's view at the time was that NGG had used an extreme buy-back price of 1.1 p/kWh/day, which had been observed in the July 2006 buy-back incident, and extreme constraint volumes, as determined using the severe LDC. Ofgem considered that if the buy-back price had been assumed to be 0.64 p/kWh/day then the expected buy-back cost would have been £13 million.

March 2008 baseline review impact assessment

3.18. For the March Impact Assessment we asked NGG to carry out further network analysis for the year 2011/12, the end of the price control period. It was considered that in total the aggregate value of all incremental signals received would increase the overall network capacity by around 37% in comparison with the 2008/9 network if NGG chose to invest. As a result it was argued that the potential annual buy-back exposure would not remain the same over the duration of the price control period.

3.19. In the March 2008 analysis NGG identified that the overall supply capability in the network would exceed forecast demand levels by 70% in 2011/12. It also concluded that lower constraint volumes would be identified in 2011/12 when compared with 2008/9 and the expected impact would be to decrease buy-back levels from those identified for 2008/9. However, NGG asserted that it could be exposed to much higher constraint volumes (and hence much higher buy-back costs) in 2011/12 than in 2008/9 because the overall capacity of the network is greater.

3.20. Ofgem did not agree that NGG would face a higher buy-back exposure in 2011/12 compared with 2008/9 arguing that if NGG is planning to invest to provide incremental capacity signalled through the QSEC auctions, backed up with firm user commitment, it must be that its buy-back exposure would decrease. We estimated the likely buy-back in 2011/12 to be between 21% and 95% of the estimated buy-back costs for 2008/9. In other words, the buy-back exposure would be between £2.7 million and £12.4 million. If NGG's exposure to buy-back decreased linearly over the remaining period of the price control, then the average exposure would be between £7.8 million and £12.7 million.

May 2008 baseline review final proposals

3.21. In our final proposals for the baseline review in May 2008 we still agreed that NGG had used a worst case scenario for estimating the expected value of buy-back costs. Therefore, if at TPCR4 we had set baselines at the level in Option 1a of the baseline review using the information from the analysis in the baseline review, we consider it would have been appropriate to set the target at £13 million. However, we did not consider it appropriate at that time to use information that had become available since TPCR4 so that we could preserve the price control settlement to the maximum extent possible so soon after the settlement had been agreed. This included information about the actual costs and frequency of buy-backs and auction signals at the 2007 QSEC auction. We thought that if we had set baselines at TPCR4 at the levels in Option 1a of the baseline review we would have set a higher target level of buy-back costs reflecting the higher risk associated with a higher aggregate level of baselines. This was the course of action we decided upon and so resulted in the target increasing to £21 million.

January 2009 entry capacity operational buy-back incentive review

3.22. However, we now consider that as part of this entry capacity operational buy-back incentive review it is appropriate to use information which has been made available since TPCR4. The analysis suggests that by using a less extreme buy-back price the expected cost of buy-back in 2008/9 would have been estimated to be £13 million with this reducing in 2011/12. However, due to changes in what the expected overall network will look like in 2011/12 since the baseline review, there is less certainty that expected buy-back costs in the latter part of the current price control period will be less than £13 million expected in 2008/9. Notwithstanding this, we note that if NGG continues to perform as it has done so far in 2008/9 that it will outperform the incentive. This analysis further suggests that the target level can be reduced and we recommend pursuing this option.

3.23. Based on the evidence provided above, our initial view is that the target value for the buy-back incentive should be reduced to a figure in the range £12.4 million (the highest value in the range of expected buy-back exposure for 2011/12) to £13 million (the expected buy-back exposure for 2008/9 calculated during the baseline review).

3.24. By reducing the target to, say, £13 million from 2009/10, consumers would benefit by £4 million each year relative to leaving the licence target value unchanged, ie, (£21m - £13m) * 50% sharing factor.

3.25. We analysed the impact that a target of £13 million would have had if it had been in place between 2002/3 and 2007/8 using the historical data. If there had been a target of £13 million in each of these years then NGG would have earned an average Incentive Revenue of £5.5 million each year (this would have been £7.5 million on average if the outlier of 2006/7 were removed from the analysis). We consider this to be sufficient incentive on NGG to contain its buy-back costs.

3.26. We have also considered the impact a £13 million target would have on NGG's return on equity. If NGG had faced a target of £13 million (instead of £18 million as it was in 2007/8) then its Incentive Revenue would have decreased by £2.5 million less tax and this would have reduced NGG's TO operation's overall real post-tax return on equity by 0.14% per cent.

3.27. While this is our provisionally preferred option, it is subject to consideration of any points raised in response to this consultation.

Option 4: Do nothing

3.28. This would leave the entry capacity operational buy-back incentive as it currently is. The advantage of this option is that it would help preserve regulatory predictability and consistency. However, it has the disadvantage of allowing NGG to continue outperforming the target, in our view, with apparent ease for the remainder of the 2007-2012 price control period. We therefore do not consider that this is an appropriate option to consider at this time. This is a provisional view and is subject to consideration of any points raised in response to this consultation.

Ofgem's proposal

3.29. On the basis of considerations at this point Ofgem's provisional view is that the entry capacity operational buy-back incentive should be changed such that the target is reduced to a figure in the range of £12.4 million to £13 million. This is because new information suggests the risk of incurring buy-back until the end of the price control period is estimated to be no more than £13 million. Also NGG from historic experience has, in our view, generally outperformed the incentive target with ease. We also consider that this target level would not materially undermine the delivery of allowed rates of return.

3.30. The potential benefits to consumers of reducing the target to £13 million are £4 million each year in the remainder of the current price control period.

Implementation

3.31. There are two options for implementation of any changes to the entry capacity operational buy-back incentive parameters, these are to implement any changes:

- Retrospectively from 1 April 2009 - since this date is the start of the 2008/9 formula year. This would require a retrospective change to the Licence since this is a four week consultation and a necessary Licence change would require a further four week consultation period which would take us beyond 1 April 2009. This approach would allow for the reduced target level to be applied for the whole formula year and allow a simple change of the Licence.
- Prospectively - this would implement the Licence changes on the first day of the month following the end of the Section 23 notice period - this would mean that the reduced target level would only apply for a fraction of the year and the target level for 2008/9 would have to be pro-rated accordingly.

3.32. Our provisionally preferred approach would be to make retrospective Licence changes; however, this is subject to consideration of any points raised in response to this consultation.

4. Review of default incremental entry capacity lead times

Chapter Summary

This chapter sets out our view that since there has only been two investment signals at the Quarterly System Entry Capacity (QSEC) auction since the Transmission Price Control Review 4 (TPCR4), which covered the period 2007-2012, it may not be appropriate to review the default incremental entry capacity lead times at this point. We therefore propose deferring reviewing this until the next transmission price control review.

Questions

Question 1: Do you agree with our proposal to defer the review of the default incremental entry capacity lead times until the next transmission price control review?

Question 2: Are there any other considerations which we have not highlighted which we should have taken into account?

4.1. The incremental entry capacity lead time is the time between the auction signal and when the incremental entry capacity is contractually delivered. In TPCR4 we increased the default incremental entry capacity lead times from 36 months to 42 months. The lead time is counted from the first day of the month following the end of the ten day QSEC auction period. NGG had argued at TPCR4 that all future releases of incremental entry capacity would take at least 48 months to deliver, with one exception. This was despite past performance indicating otherwise. Ofgem was not persuaded by the evidence presented by NGG and decided to review the length of the default incremental entry capacity lead time whilst reviewing the parameters of the entry capacity operational buy-back incentive scheme.

4.2. NGG has an additional incentive to offer and deliver incremental entry capacity in lead times of less than 42 months.

4.3. Since TPCR4 there have only been two signals for incremental entry capacity. These were at Isle of Grain in 2007 and Caythorpe in 2008 – both with incremental entry capacity lead times of 36 months. We consider this does not provide sufficient evidence on which to base a review of the default incremental entry capacity lead times.

4.4. The passing of the Planning Act 2008 will allow for the establishment of a single development consent regime for nationally significant infrastructure projects, including energy projects. At this point in time we are uncertain as to what impact the Planning Act 2008 will have on incremental entry capacity lead times. We therefore think it more appropriate to review the default incremental entry capacity lead time at the next transmission price control review.

Appendices

Index

Appendix 1 - Consultation Response and Questions

1.1. Ofgem would like to hear the views of interested parties in relation to any of the issues set out in this document. In particular, we would like to hear from transmission licensees, gas transporters, users of the transmission networks, gas terminal developers, investors, gas storage developers, consumer groups and other interested parties.

1.2. We would especially welcome responses to the specific questions which we have set out at the beginning of each chapter heading and which are replicated below.

1.3. Responses should be received by 24 March 2009 and should be sent to:

Stuart Cook
Director of Transmission
Ofgem
9 Millbank
London SW1P 3GE

Email responses should be sent to:
gas.transmissionresponse@ofgem.gov.uk

1.4. Unless marked confidential, all responses will be published by placing them in Ofgem's library and on its website www.ofgem.gov.uk. Respondents may request that their response is kept confidential. Ofgem shall respect this request, subject to any obligations to disclose information, for example, under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004.

1.5. Respondents who wish to have their responses remain confidential should clearly mark the document/s to that effect and include the reasons for confidentiality. It would be helpful if responses could be submitted both electronically and in writing. Respondents are asked to put any confidential material in the appendices to their responses.

1.6. Next steps: Having considered the responses to this consultation, Ofgem intends to publish its decision in April 2009 along with a Section 23 notice, should this be needed, to change NGG's gas transporter licence with effect from 1 April 2009, subject to views on making retrospective modifications to NGG's gas transporter licence. Any questions on this document should, in the first instance, be directed to:

Richard Miller
Senior Gas Transmission Policy Manager
70 West Regent Street
Glasgow G2 2QZ
0141 331 6013

Email questions should be sent to:
gas.transmissionresponse@ofgem.gov.uk

CHAPTER: Three

Question 1: Do you agree with the assessment we have set out for Option 1 - changing the cap and collar of the incentive?

Question 2: Do you have any views on lowering the incentive collar to better protect consumers?

Question 3: Do you agree with the assessment we have set out for Option 2 - changing the sharing factor of the incentive?

Question 4: Do you agree with our analysis of NGG's historic performance regarding the incentive?

Question 5: Do you agree with the analysis of the estimated future buy-back risk? Specifically, do you agree with NGG's application of a lognormal assumption for the distribution of buy-back costs? Do you agree with the use of historic buy-back prices in estimating future buy-back risk?

Question 6: Do you consider it appropriate to use the analysis done at the baseline review as part of forming our decision on reviewing the entry capacity operational buy-back incentive?

Question 7: Do you agree with our view that an entry capacity operational buy-back incentive target of £13 million per year will still provide NGG with sufficient incentives to contain the costs of buy-back?

Question 8: Do you consider that a £13 million entry capacity operational buy-back incentive target is appropriate given NGG's return on equity performance?

Question 9: Do you agree with our provisional view to reduce the target level of the entry capacity operational buy-back incentive to £13 million per year?

Question 10: Do you agree with the assessment we have set out for Option 4 - doing nothing and keeping the incentive in its current form?

Question 11: Do you agree with our proposed approach of retrospectively modifying NGG's gas transporter licence by implementing the proposed changes to the entry capacity operational buy-back incentive parameters as of 1 April 2009?

Question 12: Are there any other considerations which we have not highlighted which we should have taken into account?

CHAPTER: Four

Question 1: Do you agree with our proposal to defer the review of the default incremental entry capacity lead times until the next transmission price control review?

Question 2: Are there any other considerations which we have not highlighted which we should have taken into account?

Appendix 2 – Performance Measure

1.1. This appendix sets out in detail how the performance measure is calculated and provides some examples of how the performance measure is calculated and how this impacts on the Incentive Revenue for additional clarity.

1.2. The specific formula for the performance measure is included in Special Condition C8D(3)(b) of NGG's gas transporter licence, and is given below:

Performance Measure = Total Capacity Constraint Management Costs – Revenue from on-the-day sales of obligated entry capacity – Revenue from interruptible entry capacity – (Revenue from non-obligated entry capacity – Revenue from accelerated release of incremental obligated entry capacity) – Revenue from entry overrun charges – Revenue from locational sell actions and physical renomination incentive charge – Any other NGG revenue the Authority directs to include in formula

1.3. The total capacity constraint management costs were described previously in paragraph of the main document and include the cost of buy-backs of operational entry capacity i.e. all except for the buy-back of funded incremental entry capacity signalled after 31 March 2007 or specific entry capacity at Milford Haven. Therefore, NGG is incentivised to reduce the cost of buy-backs whilst increasing the revenue from sales of baseline entry capacity on the gas flow day, interruptible capacity and discretionary amounts of capacity which NGG makes available above the baseline, amongst other things.

1.4. To aid understanding of how buy-back costs translate into the Incentive Revenue earned by NGG two examples are used for illustrative purposes. In both examples:

- Revenue from on-the-day sales of obligated entry capacity = £1m
- Revenue from interruptible entry capacity = £1m
- Revenue from non-obligated entry capacity = £2m
- Revenue from accelerated release of incremental obligated entry capacity = £1m
- Revenue from entry overrun charges = £1m
- Revenue from locational sell actions and physical renomination incentive charge = £1m
- Both of these examples assume that the "Any other NGG revenue the Authority directs to include in formula" component = £0

1.5. In example 1 we assume that buy-back costs (i.e. total capacity constraint management costs) = £10m. In example 2, we assume that buy-back costs (i.e. total capacity constraint management costs) = £40m.

Example 1
Performance Measure=£10m – £1m – £1m – [£2m–£1m] – £1m – £1m – £0=£5m

1.6. Since the performance measure is less than the £21 million target then the incentive revenue is calculated as follows:

Incentive Revenue = Minimum [Sharing factor x (target–performance measure), upside cap] = Minimum [50% x (£21m – £5m), £18] = Minimum [£8m, £18m]

1.7. Since £8 million is less than the upside cap of £18 million then in this example the incentive results in an increase of £8 million in NGG's allowed SO revenue.

Example 2
Performance Measure=£40m – £1m – £1m – [£2m–£1m] – £1m – £1m –£0=£35m

1.8. Since the performance measure is greater than the £21 million target then the incentive revenue is calculated as follows:

Incentive Revenue = Maximum [Sharing factor x (target – performance measure), downside collar] = Maximum [50% x (£21m – £35m), -£18] = Maximum [-£7m, -£18m]

1.9. Since -£7 million is greater than the downside collar of -£18 million then in this example the incentive results in a reduction of £7 million in NGG's allowed SO revenue.

1.10. In this example, when the performance measure exceeds £57 million, suggesting large buy-back costs, then the incentive downside collar kicks in and NGG's revenue reduction from the incentive is limited to £18 million.

1.11. It may seem perverse that the performance measure increases (and therefore NGG's Incentive Revenue decreases) as the amount of revenue from accelerated release of incremental obligated capacity increases, as accelerated release of incremental obligated capacity would be something that we want to encourage. However, revenue from accelerated release of incremental obligated capacity is already included in the three components which make up the maximum revenue that NGG can earn from the entry capacity operational buy-back incentive, as stated in paragraph 2.6 of the main document, so NGG is already incentivised to accelerate the release of incremental obligated capacity through that channel.

1.12. Similarly it may seem odd that the performance measure incentivises NGG to reduce Total Capacity Constraint Management Costs when the maximum revenue that NGG can earn from the entry capacity operational buy-back incentive includes the Total Capacity Constraint Management Costs directly. However, NGG recovers the costs it has spent on buying capacity back through the Total Capacity Constraint Management Costs item and so has no net gain or loss from this and the Incentive Revenue is there to reward/penalise NGG in terms of its performance for reducing buy-back costs.

Appendix 3 – 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.[22]

1.3. Duties and functions relating to gas are set out in the Gas Act and those relating to electricity are set out in the Electricity Act. This Appendix must be read accordingly[23].

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 existing and future consumers, wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities connected with, the shipping, transportation or supply of gas conveyed through pipes, and the generation, transmission, distribution or supply of electricity or the provision or use of electricity interconnectors.

1.5. The Authority must when carrying out those functions have regard to:

- the need to secure that, so far as it is economical to meet them, all reasonable demands in Great Britain for gas conveyed through pipes are met;
- the need to secure that all reasonable demands for electricity are met;
- the need to secure that licence holders are able to finance the activities which are the subject of obligations on them[24];
- the need to contribute to the achievement of sustainable development; and
- the interests of individuals who are disabled or chronically sick, of pensionable age, with low incomes, or residing in rural areas.[25]

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[22] entitled "Gas Supply" and "Electricity Supply" respectively.
[23] 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.
[24] 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.

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:

- promote efficiency and economy on the part of those licensed[26] 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; 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.

The Authority has powers under the Competition Act to investigate suspected anti-competitive activity and take action for breaches of the prohibitions in the legislation in respect of the gas and electricity sectors in Great Britain and is a designated National Competition Authority under the EC Modernisation Regulation[27] 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.

[25] The Authority may have regard to other descriptions of consumers.
[26] or persons authorised by exemptions to carry on any activity.
[27] Council Regulation (EC) 1/2003

Appendix 4 - Glossary

A

The Authority (Ofgem)

Ofgem is the Office of Gas and Electricity Markets, which supports the Gas and Electricity Markets Authority (GEMA), the body established by Section 1 of the Utilities Act 2000 to regulate the gas and electricity markets in Great Britain.

B

Baseline

Baselines define the levels of non-incremental entry capacity that the transmission licensee is obligated to release. Baselines also determine the levels above which incremental capacity is defined.

Baseline Review

This reviewed the entry capacity baselines which were set at the Fourth Transmission Price Control Review (TPCR4). The review concluded in May 2008 and the result was that baselines increased slightly at a number of entry points whilst the entry capacity operational buy-back incentive target was increased from £18 million to £21 million in 2009/10, with an interim figure of £20.25 million in 2008/9.

Buy-back

The process of compensating users if National Grid Gas (NGG) is unable to deliver entry capacity which is sold on a financially firm basis.

E

Entry Capacity Operational Buy-back Incentive

This is the scheme set out in Special Condition C8D(3) of National Grid Gas's (NGG's) gas transporter licence. It has a number of main aims, these are to incentivise NGG to (i) contain the costs from buy-back of entry capacity other than that of incremental entry capacity (ii) release incremental entry capacity on an accelerated timescale compared to the default incremental entry capacity lead time of 42 months (iii) increase sales of certain entry capacity products including on-the-day sales, interruptible and non-obligated.

F

Firm Entry Capacity

This is entry capacity which provides the user with firm entry capacity rights. In the event of a constraint National Grid Gas (NGG) cannot simply interrupt these users - it would have to buy these firm rights back from the user.

G

Gas Distribution Network (GDN)

GDNs transport gas from the National Transmission System (NTS) to final consumers and to connected system exit points. There are currently eight GDNs in Great Britain, four of which are owned by National Grid Gas plc, and four of which were sold by Transco plc (now National Grid Gas plc) to third party owners on 1 June 2005.

I

Incentive Revenue

This is defined in Special Condition C8D(3)(a) of National Grid Gas's (NGG's) gas transporter licence as the term $EnCOBBIR_t$. It is the amount of revenue that NGG can earn (or lose) depending on its performance in relation to incurring buy-back costs and revenue from the sale of various entry capacity products (including on-the-day sales, interruptible and non-obligated).

Incremental Entry Capacity

Entry capacity in addition to the baseline (and previous signals of incremental entry capacity) which National Grid Gas (NGG) releases for allocation. Obligated Incremental Entry Capacity is capacity which has been signalled to be released as a result of a Quarterly System Entry Capacity (QSEC) auction.

Incremental Entry Capacity Lead Times

This is the time between the signal for incremental capacity and when National Grid Gas (NGG) is contractually obliged to deliver that capacity. Specifically, for entry capacity it begins on the first day of the month after the ten day Quarterly System Entry Capacity (QSEC) auction period. Currently the licence sets the default incremental entry capacity lead time at 42 months.

Independent Gas Transporter (IGT)

IGTs are gas transporter licence holders that own and operate small local gas networks and levy distribution charges on shippers.

Interruptible Entry Capacity

This is entry capacity which does not provide the user with firm entry capacity rights. In the event of a constraint National Grid Gas (NGG) can remove the rights of holders of interruptible entry capacity to flow gas onto the National Transmission System (NTS).

M

Maximum Allowed SO Revenue

This is the maximum amount of revenue that National Grid Gas (NGG) is allowed to earn in its role as system operator. It is mainly comprised of amounts that NGG can earn from its performance in relation to a number of incentives.

N

National Grid Gas (NGG)

The licensed gas transporter responsible for the gas transmission system, and four of the regional gas distribution companies.

National Transmission System (NTS)

The high pressure gas transmission system in Great Britain.

Non-obligated Incremental Entry Capacity

This is entry capacity which National Grid Gas (NGG) makes available in addition to the levels of capacity it is obligated to make available for sale. These obligated amounts consisting of baselines and incremental entry capacity.

O

Obligated Entry Capacity

This is the amount of entry capacity that National Grid Gas (NGG) is obligated by its gas transporter licence to offer for sale.

Q

Quarterly System Entry Capacity (QSEC)

Firm National Transmission System (NTS) Entry Capacity which may be bid for in the Quarterly System Entry Capacity (QSEC) auctions and registered as held by a user for each day in a particular calendar quarter. Entry capacity is sold forward via QSEC Auctions which offer capacity at each aggregate system entry point between two and sixteen years in advance.

S

System Operator (SO)

The System Operator (SO) has responsibility to construct, maintain and operate the National Transmission System (NTS) and associated equipment in an economic, efficient and co-ordinated manner. In its role as SO, National Grid Gas (NGG) is responsible for ensuring the day-to-day operation of the transmission system.

T

Transmission Price Control Review 4 (TPCR4)

TPCR4 established the price controls for the transmission licensees and took effect in April 2007 for a 5-year period. The review applies to the three electricity transmission licensees, National Grid Electricity Transmission (NGET), Scottish Power Transmission Limited (SPTL), Scottish Hydro Electric Transmission Limited (SHETL) and to the licensed gas transporter responsible for the gas transmission system, National Grid Gas (NGG).

U

Uniform Network Code (UNC)

As of 1 May 2005, the UNC replaced National Grid Gas's (NGG's) network code as the contractual framework for the National Transmission System (NTS), Gas Distribution Networks (GDNs) and system users.

Appendix 5 - Feedback Questionnaire

1.1. Ofgem considers that consultation is at the heart of good policy development. We are keen to consider any comments or complaints about the manner in which this consultation has been conducted. In any case we would be keen to get your answers to the following questions:

1. Do you have any comments about the overall process, which was adopted for this consultation?
2. Do you have any comments about the overall tone and content of the report?
3. Was the report easy to read and understand, could it have been better written?
4. To what extent did the report's conclusions provide a balanced view?
5. To what extent did the report make reasoned recommendations for improvement?
6. Please add any further comments?

1.2. Please send your comments to:

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