Windsor

www.centrica.com

Mr. Stuart Cook
Director of Transmission
Ofgem
9 Millbank
London
SW19 3GE

24 March 2009

Dear Stuart,

RE: Review of Entry Capacity Operational Buy-back Incentive and default Incremental Entry Capacity Delivery Lead Time

Thank you for the opportunity to comment on this proposal. This response is sent on behalf of the Centrica Group of companies excluding Centrica Storage Limited.

The Gas Forum, of which Centrica is a member, has commissioned a piece of work to consider this Ofgem consultation. We fully agree with the findings of that piece of work (a copy of which is appended this letter) and therefore that piece of work should also be considered as a response from Centrica.

Should you have any queries with regard to this response please do not hesitate to contact me.

Yours sincerely,

Chris Wright
Commercial Manager

centrica energy

CHAPTER THREE

Entry capacity operational buy-back review

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

Response 1:

The Gas Forum agrees with the Ofgem position that changing the cap and collar is not the best means to set an appropriate incentive for the next 3 year period.

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

Response 2:

We are not convinced that such a change would have any material impact on the behaviour of NGG given its history of significant outperformance. This applies even at the reduced level of target proposed by Ofgem in Option 3.

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

Response 3:

We agree that lowering the target (Option 3) is the most appropriate way to reflect the latest knowledge (see Response 5 below) and therefore agree that leaving the sharing factor unchanged is appropriate at this stage.

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

Response 4:

We agree with Ofgem's broad analysis but make the point that the July 2006 buy back costs as a result of the connection of a baseline related project at Easington (the cross Pennine link) were one-offs and cannot be repeated as there does not appear to be any significant 'existing baseline capacity' related capex projects. This means that a major source of risk (as witnessed in July 2006) no longer exists.

The problems in July 2006 in relation to work to connect new gas pipelines in the Easington area indicated the type of problem that can arise when new pipelines are connected and commissioned. However, in that case, >95% of the net £28 Million constraint management costs were incurred at St Fergus as at that time there were still high St Fergus flows (prior to Langeled).

Now that the cross–Pennine link is fully operational, the construction and operational risks have been reduced.

If the historic figures are looked at without the July 2006 incident then the average Incentive Revenue rises to around £11.5 Million which is very high and indicates that the target level has been too low.

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?

Response 5:

No, the Gas Forum believes that fundamental changes have taken place since the existing entry capacity operational buy-back incentive was set (we assume using 2005 10YS figures given the consultations were in 2006). These are of such a scale that the NGG lognormal assumption has been overtaken.

The key changes are:

a. Reduction in gas demand (peak demand forecast in the 2008 10YS is around 10% lower than in the 2005 10YS as shown below:

	2007/08	2008/09	2009/10	2010/11	2011/12
2008 10 YS forecast	5,723	5,810	5,850	5,916	5,979
2005 10 YS forecast	6,099	6,272	6,439	6,547	6,688
% reduction in peak demand from 2005 - 2008	6.17%	7.36%	9.15%	9.63%	10.59%

- Lower demand reduces the risk of constraints at all periods in the year

b. Dramatically lower use of compressors than was forecast in 2005. At that time NGG assumed a large programme of replacement compressors for emissions reasons, the 2008 10YS only shows 2 such machines rather than a total of nine indicated in the 2006 10YS. The 2008 10YS indicates that there is les than half the use of compressor fuel compared to the 2002-2005 period.

- o Lower use of compressors significantly reduces risk of constraints

c. There are no longer any major baseline related capex projects that give rise to the risk of constraints (as July 2006). The new compressor programme for emissions was envisaged and it would have increased the risk of constraints but this is no longer taking place in the period 2009-2012.

d. Decline in UKCS flows. The entry capacity operational buy-back incentive is largely focused on the older parts of the NTS with UKCS flows together with imports at Bacton and Easington. Comparing the 2005 and 2008 10YS forecasts for UKCS shows:

- o NGG's forecast for UKCSflows are 18% lower for 2009/10, 13% for 2010/11 and 7% for 2011/12.

- o The flows from the UKCS are forecast to be 51% lower in the 2009-2012 period compared to the average in 2000 to 2005.

All the above factors indicate that NGG's lognormal assumption for future costs has been overtaken by events. Given the above changes since 2005, diversity in NTS entry flows going forward and the greater diversity of shippers market share it can reasonably be argued that actual buy-back prices (in the event of any constraints) should be lower than historic prices.

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?

Response 6:

Yes, but we would also challenge that data as we do not feel it has reflected the points a – d in response 5 above.

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?

Response 7:

Yes, given we make the case above that there is now significantly reduced risk of constraints arising.

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?

Response 8:

Whilst we can show that risks have reduced (5 a-d above), we believe that had risks moved in the other direction with higher gas flows at St Fergus, higher demands, the need (for example) to replace NTS pipelines etc, NGG may have been arguing for a higher incentive target.

In this instance, the risks have significantly reduced and hence the target needs to be reduced to maintain an appropriate balance between risk and reward. Not making an adjustment would overly reward NGG.

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?

Response 9:

Yes.

However, even the £13 Million proposed by Ofgem may be too high given the different risk profile than now applies compared to the position when the original incentive was set.

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?

Response 10:

No, given the changes in the risk of constraints this is not appropriate, especially since it was always envisaged that there would be a review after 2 years to take into account new circumstances.

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?

Response 11:

Yes

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

Response 12:

In addition to the points in Response 5, we believe that there is now a lack of transparency as to what investment NGG is making in relation to incremental NTS capacity. Whist this is subject to a separate incentive, it would be very useful if NGG was asked to set out the following data for investments being made in response to new entry capacity. This would help with transparency and understanding and would support the work underway in relation to Substitution and RG221 (credit arrangements in relation to entry capacity).
The information requested is:

- Name of ASEP
- Date of auction which passed the NPV test for new capacity
- Size of the NPV bid
- Increase in capacity as a result of NPV bid
- Name and description of projects being built to provide the capacity
  - NGG have advised in RG221 that their process includes going to their Board for submission for any NTS capex projects that they believe necessary to deliver new capacity.
- Schedule for each project including major milestones (planning, award of construction contract, completion etc)
- Incentive income to NGG for each successful bid (based on revenue drivers)
- For completed projects (such as related to Milford Haven) a report on the total capex incurred and how the incentive mechanism will operate (comparison with revenue drivers etc)

We believe that this information should be updated at least once per annum and published on the NGG website and in the NGG 10YS.

It will also be useful in informing the appropriate level of revenue drivers for each ASEP in the next TPCR and also in informing the debate on entry capacity lead times.

CHAPTER FOUR

Review of default incremental entry capacity lead times

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?

Response 1:

The Gas Forum supports Ofgem's view that any review of the default entry capacity lead times is deferred until the next transmission price control.

We consider this to be a material change to the entry regime and as such warrants rigorous scrutiny. Before any decision is taken we would like to see a thorough examination of the evidence supporting an extension of lead times together with an assessment of the likely impacts any extension could have on Users of the NTS.

This should include gas storage developments and small field developments and include an assessment of the impact on security of supply and competition. Canatxx's acquisition of entry capacity at Fleetwood acts as a useful example of the unintended consequences that can arise when entry capacity lead times and project development milestones become misaligned.

We agree with Ofgem that any review of lead times should recognise the impact of the Planning Act 2008. This will hopefully become clearer before the next price control; we understand that the Infrastructure Planning Commission (IPC), set up under the Act, will start accepting applications in 2010.

As Ofgem may recall, the amendment to introduce Gas Transporter (GT) pipe lines into the Planning Act was to ensure that consents for high pressure gas pipelines and the associated Above Ground Installations (AGIs) could be determined simultaneously by the IPC.

Previously, the gas pipelines required Environmental Impact Assessment (EIA) consent from the Secretary of State and TCPA permission for associated works on the pipeline. For large projects such as the Milford Haven pipeline, this could involve applications to a number of authorities. The case for including Gas Transporter pipelines in the IPC regime was made by National Grid and the four main distribution companies as they saw significant benefits in obtaining a single development consent for all the components of a major project. The benefits discussed during Planning Round Table debates included speeding up the process and providing a more certain outcome. Any deviation from this stated position would need thorough examination and explanation.

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

Response 2:

There may be other factors but these are not material at this stage in relation to deferring the review to the next transmission price control review.

We do however, believe that the information set out in Response 12 to Section 3 would also be very useful in informing review of lead times.