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Stuart Cook
Director of Transmission
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Our Reference:
Your Reference:

Date : 25 March 2009

Dear Stuart,

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

SSE welcomes the opportunity to comment on the above consultation document.

NGG's operational buy-back incentive allows National Grid Gas to increase allowed revenue where costs associated with buying back capacity (other than incremental capacity signalled after March 2007) are contained. Revenue can also be increased where NGG releases incremental obligated entry capacity ahead of the standard investment lead time. SSE believes both elements of the incentive are largely within NGG's control; as such it is appropriate that they remain incentivised. There is strong evidence to show that incentive regulation can drive improvements in performance and efficient behaviour. However we believe rewards should be proportionate to risk and benefits should be shared with customers. NGG has significantly outperformed relative to targets in most recent years, earning between £6m and £16m under this one incentive mechanism alone. This is significant when compared against the target and actual level of costs. We believe benefits to NGG are disproportionate relative to risk and benefits obtained by customers. As such we support the proposal to tighten the target going forward.

NGG has questioned the rational behind making changes at this time and the target level proposed by Ofgem. We believe it has always been clear that incentive arrangements would be reviewed. Although it is not clear what new information Ofgem has relied on, or what it has considered to be the key cost drivers, there is significant historical evidence regarding actual costs incurred which support the target proposed. In addition, information presented under the TBE process and Ten Year Statement suggest the level of costs going forward are likely to be lower still. Although the £13m target proposed by Ofgem is a significant reduction compared to the existing target of £21m, we believe it should be achievable and still provides an opportunity for NGG to outperform and gain some benefit. In particular information presented under the TBE process and TYS indicates:

- The future level of demand for gas is likely to be lower than that originally anticipated at the time the target was initially set.
- Whilst there is still uncertainty regarding UKCS supplies, they are forecast to reduce more rapidly than we believe was forecast at the time the incentive was originally set.
- We believe new sources of gas supplies are likely to result in a more balanced system going forward, with less reliance on St Fergus flows.
- Most importantly, new investment has been completed since the initial target was set, in response to QSEC auction signals.

We believe all of the above should reduce the need for operational buy back actions going forward, compared to those originally anticipated at the time the target was set. Combined with actual performance over the last two years, we believe there is compelling evidence to suggest significant target tightening is appropriate.

In relation to plans to review the 42 month lead time for investment, SSE does not believe there is any compelling evidence to support an increase to 48 months. We believe the current mechanisms which allow NGG to review projects on a case by case basis and refer any projects which might require a longer period to Ofgem has been proven to cope well with the exception. If anything, SSE believes it provides too much protection to NGG and does not adequately compensate industry participants where investments is not delivered on time. That said we believe it would be inefficient to make 48 months the norm. We agree with Ofgem’s suggestion to leave the lead time at 42 months, and to review this again at the next TPCR where a holistic review can be carried out and appropriate solutions put in place. In the meantime, we urge Ofgem to encourage NGG to revisit compensation arrangements under the Entry Capacity Release Methodology.

In relation to process, we note that this is the first consultation document we have seen in relation to the above, and no further consultations are planned. Ofgem plans to issue a decision document in April, accompanied by Section 23 notice. We do not believe a single stage consultation process provides sufficient opportunity to seek clarification, address points raised by respondents or consider alternatives. Also, this consultation has been initiated very close to the end of the incentive year, making it unlikely that arrangements will be finalised before the start of the next incentive year. This introduces uncertainty and risk for NGG and market participants. We would urge Ofgem to initiate the process earlier in future to allow time for a two stage consultation process and to reach a conclusion before the start of the next incentive year. In the meantime, we do not support retrospective application of new arrangements. It is illogical to implement a mechanism to incentivise efficient behaviour after actions have been taken and when there is no opportunity to respond. Although retrospective application of changes has been used on a number of occasions recently, we do not believe this creates a good precedent.

More detailed comments on each individual question raised within the consultation document are set out in the appendix attached. We hope you find them helpful.

Yours sincerely

Beverley Grubb
Regulation Manager

Appendix 1

Chapter 3

1. **Do you agree with the assessment we have set out for Option 1 – changing the cap and collar of the incentive?**
   Whilst Ofgem does not plan to amend the cap or collar at this stage, we believe it should be reviewed going forward. An upside cap of £18m and a downside collar of -£18m appear to be disproportionate relative to a target of £13m. Also, NGG has realised considerable benefit under the incentive mechanism over the years. This does not appear to reflect the level of risk or be balanced with benefits realised by customers.

2. **Do you have any views on lowering the incentive collar to better protect consumers?**
   Please see response to question 1 above.

3. **Do you agree with the assessment we have set out for Option 2 – changing the sharing factor of the incentive?**
   As noted under question 1, we believe the benefits realised by NGG under the incentive have been disproportionate. We believe a greater share of benefits should be passed on to customers. Whilst consideration should be given to amending the caps and collars going forward, sharing factors provide a better way of balancing risk / reward whilst ensuring NGG remains incentivised, even at the extremes. All elements should be considered at the next review to ensure a balanced incentive regime. In the meantime it is more important that the target is set at an appropriate level. We can build from here.

4. **Do you agree with our analysis of NGG's historic performance regarding the incentive?**
   We agree with the analysis presented by Ofgem; there is strong evidence to show that NGG has significantly outperformed relative to target in most years and realised significant financial benefits. We believe costs incurred in 2006/07 were related to a specific event that is unlikely to be repeated. Where specific or unexpected events occur in future, there are other appropriate mechanisms under the regulatory framework that can be used to make adjustments. This is more appropriate than trying to deal with uncertainty within the normal incentive target.

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?**
   It is not clear what new information Ofgem has relied upon, or the extent to which this has influenced the target. However, it appears that Ofgem has considered actual performance and changes which are likely to influence future behaviour. Given some of the fundamental changes anticipated going forward, we believe it is important that too much weight isn't given to historical data.

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?**

As stated above, we believe it is important to update assumptions taking into account new information as it comes to light e.g. changes in demand, new supply flows, network investment etc. All these factors are likely to influence operational buy back costs going forward.

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?**
   Yes, although given some of the new information and updated views presented through the TBE process and in the TYS there may be scope to reduce this further. Whilst we are not proposing this at this stage, we believe it should be kept under review.

8. **Do you consider that a £13 million entry capacity operational buy-back incentive target is appropriate given NGG's return on equity performance?**
   As stated above, it is important that the incentive mechanism strikes a balance between risk and reward and is set to drive realistic improvements in performance. The target proposed by Ofgem is appropriate but it could be argued the cap and collar are too wide. We are not clear that the incentive mechanism should be used to deliver a return on equity. This should not be the main function of the incentive mechanism.

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?**
   Yes. Please see comments detailed above.

10. **Do you agree with the assessment we have set out for Option 4 – doing nothing and keeping the incentive in its current form?**
    Yes. Given the significant potential to continue to outperform, we do not believe this is a credible option.

10. **Do you agree with our proposed approach of retrospect9vely 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?**
    No. We do not support retrospective application. As stated above, this is illogical given actions have already been taken and there is no opportunity to respond to the incentive mechanism.

11. **Are there any other considerations which we have not highlighted which we should have taken into account?**
    Going forward we would like to see greater level of transparency regarding the actual level of costs incurred under incentive mechanisms and updated forecasts.

Chapter 4

1. **Do you agree with the proposal to defer the review of the default lead time until the next transmission price control review?**

As stated above, we believe deferral is appropriate. We are not aware of any significant issues that have arisen under the current arrangements. The existing arrangements have been shown to cope with exceptional situations where a longer lead time may be required. We believe it is appropriate to consider each on a case by case basis rather than extend the lead time for all. By deferring consideration until the new TPCR a holistic and thorough review of the issues and potential solutions can be undertaken.

2. **Are there any other considerations which have not been highlighted which we should have taken into account?**
None that we are aware of.