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Our Reference MR/Ofgem/28/11

Dear Paul,

**“Income Adjusting Event claim for the Canatxx incremental entry capacity signal at Fleetwood”
Ofgem Consultation Letter 7th March 2011**

Thank you for the opportunity to comment on your open letter concerning Centrica Energy's notice of what it considers to be an income adjusting event (“IAE”) for the purposes of paragraph 3(b) Condition C8C (NTS System Operation Activity Revenue Restriction) (the “Condition”) of the gas transporter licence of National Grid plc (“National Grid”) in respect of the gas National Transmission System (the “NTS licence”). This response is made on behalf of National Grid as NTS licensee.

On a general level, National Grid is concerned that a determination by the Authority that an IAE has taken place will undermine the incentive arrangements agreed in TPCR3 and TPCR4 and set out in the NTS licence. National Grid considers that any set of incentive arrangements can only properly be viewed in the context of the price control “package” as a whole. Price controls are set to incentivise licensees to develop, maintain and operate their networks in an economic and efficient manner and National Grid is concerned that the use of IAE, or other similar mechanisms, could lead to:

an undermining of the incentive properties of the particular arrangements agreed at the time of the price control; and, as a result,

an increase in network operators' perceived risk profile with investors, with a consequential impact on their costs of capital.

The SO entry capacity investment scheme, when viewed across all relevant entry points, has led to National Grid both under- and over-performance against the incentives. While National Grid agrees that, to date, it has actually spent less money in respect of the Fleetwood project than the implied investment costs used to derive its allowed revenue; there are also schemes where it has invested more than the costs implied by the allowed revenue. This demonstrates further that the incentive arrangements should be viewed as a package and that the appropriate route, to decide whether a more fundamental review of how the NTS licence incentive arrangements work, should be through the RIIO-T1 discussions.

National Grid has clearly responded to the entry incentive and the auction signal to release capacity at Fleetwood in an economic and efficient manner and hence should retain the allowed revenue in its entirety. National Grid notes that the terms of the TPCR3 settlement mean that in 2012 there is a “truing-up” adjustment made to the TO RAV which effectively means that the actual spend less SO deemed spend is added to the RAV, with a further adjustment in 2017 being made to add back the SO deemed spend to the TO RAV. This effectively means that there is a period of only 18 months when National Grid receives incentive revenues in accordance with the TPCR3 settlement. From April 2012, National Grid is effectively fully funded only for its efficient actual spend; hence the benefit of this strategy is shared with consumers.

National Grid would stress that in the event that the Authority effectively reduced incentive revenue through the mechanism of an IAE, this would leave significant ambiguity should planning permission be granted for a facility connected at Fleetwood or should a similar situation arise at another entry point. The development of a project that will use entry capacity at Fleetwood remains a credible outcome as Halite Energy Group has taken over the Fleetwood project with the intention of gaining planning consent and using the facility for the storage of gas. If no adjustment were to be made to National Grid's capacity release obligations, the obligation on National Grid to make capacity available at Fleetwood through all relevant entry capacity auctions would continue to exist and capacity could be acquired relatively cheaply on a within-day basis at the Fleetwood entry point as a consequence of the clearing obligation and associated zero reserve price. This would then leave National Grid with the risk of being required to deliver that capacity but no revenue from which to finance it. If this were to occur, National Grid might find itself in the position of having to raise an IAE itself to obtain appropriate funding, which would clearly create significant uncertainty.

With regard to the notified IAE covered by the consultation, National Grid does not believe it is clear that *"the commencement of the collection of Canatxx revenues by NGG through the SO commodity charge"* can constitute a relevant "event or circumstance" that can have had any effect on National Grid's "relevant system operation costs". The collection of revenues is not relevant to National Grid's costs, which relate to the construction of physical assets and the costs of any commercial actions.

In summary, National Grid does not believe that the notified event should be defined as an IAE in accordance with the NTS Licence. In this light, National Grid does not consider that it is appropriate for the Authority to determine any adjustment to its revenues in response to Centrica Energy's notice of an IAE.

Detailed answers in relation to the specific questions raised by Ofgem in its consultation letter are included in the attached addendum.

Please do not hesitate to contact me if you wish to further discuss any aspect of this response.

Yours sincerely,



Mark Ripley
Regulatory Frameworks Manager

Q1 a) Do you consider that an IAE has occurred? & b) What is the basis of your conclusion?

National Grid notes that the definition of "income adjusting event", for the purposes of SORA_t in paragraph 3(b) of the Condition, does, as Centrica Energy point out, provide for events or circumstances other than those listed at paragraphs (A) to (C) to be income adjusting events if the Authority considers that they are such. In order for the event to qualify as an income adjusting event, the event *itself* must have increased or decreased the value of "relevant system operation costs"¹ for the relevant formula year.

National Grid does not believe it is clear that *"the commencement of the collection of Canatxx revenues by NGG through the SO commodity charge"* can have had any effect on National Grid's "relevant system operation costs": these are defined in Special Condition C8A (Revenue Restriction Definitions etc) as:

"those costs associated with the licensee's conduct of the NTS system operation activity and/or transportation owner activity".

The collection of revenues is clearly not relevant to this.

National Grid believes that commencing revenue collection is not, and cannot be, an IAE for the purposes of SORA_t, especially since the language of sub-paragraph (iii) of paragraph 3(b) of the Condition requires the notice from the shipper to demonstrate that costs or expenses have been saved by an IAE; the collection of revenues has no bearing on this.

In addition, National Grid considers that the rule set out in paragraph 3(b) (vi) of the Condition that

"a notice of an income adjusting event shall be given as soon as is reasonably practicable after the occurrence of the income adjusting event, and, in any event, not later than three months after the end of the relevant formula year t in which it occurs"

means that the refusal of planning permission cannot, obviously, form the basis of a valid notice of an IAE in respect of revenues for the formula year 2010/11. While Centrica Energy does not make this argument in its notice, National Grid considers that other respondents may seek to claim that an IAE has taken place on this basis. National Grid considers that, even if the refusal of planning permission to Canatxx for the storage facility at Fleetwood were deemed to be a relevant event leading to reduced costs for National Grid, it could not form the basis of a valid IAE notice as it did not occur during the relevant formula year (2010/11) in respect of which Centrica Energy claim the IAE has taken place.

In summary, National Grid believes that the notice from Centrica Energy purports to base an IAE on a trigger point that cannot itself be an IAE and, as such, believes that the IAE may be technically defective in as much as it does not identify an event which has had any effect on National Grid's costs or expenses.

Q2. Do you consider that any or all the costs saved by NGG are associated with the IAE?

National Grid is of the view that any cost savings associated with Fleetwood represent an economic and efficient response to the SO entry incentive and are not associated with the IAE identified by Centrica in the notice.

¹ Or the value of IOC_t or ICE_t, neither of which are relevant in relation to the SO Entry Investment incentive and the Fleetwood incremental capacity release.

Q3. Has the IAE increased or decreased the relevant system operation costs by more than the £2 million threshold?

The assumptions underlying the entry capacity incentive and the calculation of the revenue drivers are that investment is assumed to occur in the two years preceding the provision of the capacity with 20% of costs incurred in the first year and 80% in the second year. In line with this, the assumption National Grid made in the context of the release of capacity at Fleetwood was that the costs would be incurred in the formula years 2008/9 and 2009/10 (being the two formula years prior to the provision of the capacity). National Grid also assumed that it would incur no substantial costs in formula year 2010/11 and no costs were, in fact, incurred in that year. As a result, for the purposes of determination of the IAE, relevant system operation costs in formula year 2010/11 have neither increased nor decreased.

It should also be noted that National Grid has incurred actual costs of £9.9m (£10.5m at 2010/11 prices) prior to the 2010/11 formula year, which approximates to the value of the revenue that is being recovered in the 2010/11 formula year ~ £10.89m. As a result, even if the Authority were to determine that an IAE had taken place in respect of the formula year 2010/11, no adjustment to National Grid's revenue would be appropriate for that year on the basis that efficient expenditure already incurred should be funded.

Q4. If the Authority concludes that an IAE has occurred, how should we calculate an adjustment figure that ensures that the financial position and performance of NGG is, so far as reasonably practicable, the same as if the IAE had not occurred?

As indicated in the response to Question 3 above, if the Authority concludes that an IAE has occurred, National Grid believes that it is not appropriate for any adjustment to be made to its revenues for the formula year 2010/11. Indeed, National Grid considers that any adjustment to its revenues should be considered only from the start of the next revenue control period and should be implemented hand-in-hand with corresponding adjustments to its capacity release obligations. As noted above, National Grid has incurred actual costs of £9.9m (£10.5m at 2010/11 prices) to date, which approximates to the value of the revenue that is being recovered in the 2010/11 formula year ~ £10.89m.

National Grid notes that Centrica Energy suggests that the costs incurred should be recovered over a five year period. National Grid believes that this is inconsistent with the incentive structure as this project was funded via the TPCR3 arrangements. There is an eighteen month period (not five years) prior to the "truing-up" from 1st April 2012. Furthermore, the treatment suggested by Centrica Energy takes no account of inflation, return on investment, or financing costs.

National Grid also believes that, if the Authority concludes that an IAE has occurred, it would no longer be appropriate for the obligation to make capacity available at Fleetwood to apply. Removal of this obligation could be achieved by removing the Fleetwood obligation from Table 8 in Part C in Special Condition C8D (NTS gas entry incentives, costs and revenues) of the NTS licence. As such, if the Authority was to conclude that an IAE has occurred, removal of the obligation to make capacity available must form part of ensuring:

"that the financial position and performance of [National Grid is], insofar as is reasonably practicable, the same as if that income adjusting event had not taken place"

for the purposes of its determination of the IAE.

National Grid notes that the way the IAE rules work is such that an IAE would need to be raised in respect of each year separately; however, removal of the Fleetwood capacity release obligation, as part of the 2011/12 PCR roll-over, would end the SO incentive in relation to Fleetwood and would, therefore, remove the requirement for any future Fleetwood related IAEs.

Q5. Are there any additional factors or evidence which you think Ofgem should take into account to inform the Authority's decision?

As no Fleetwood entry capacity auction revenue was anticipated to be received from Canatxx in 2010/11, the Fleetwood allowed revenue under the 2002-2007 entry capacity incentive arrangements (£10.89m) for 2010/11 was recovered through the SO Commodity Charge in line with the incentive arrangements.

Centrica Energy's notice seems to imply that, if National Grid were to have spent £5m, it should be able to recover £1m over each of the first five years of the incentive period. This approach makes no allowance for inflation, return on investment, or financing costs. The assumption that costs should be recovered over five years may also represent a misunderstanding of the incentive arrangements by Centrica Energy for the following reasons: the terms of the TPCR3 settlement mean that from 1st April 2012 there is a "truing-up" adjustment made to the TO RAV which effectively means that the actual spend less SO deemed spend is added to the TO RAV, with a further adjustment in 2017 being made to add back the SO deemed spend. This effectively means that National Grid's will outperform against the incentive revenues only over an 18 month period.

Ofgem notes that, should the capacity obligation remain, all further system modelling would need "to include the potential for Fleetwood flows at a level of 650 GWh per day". National Grid notes that because of the "truing-up" adjustment to be made to the TO RAV from 1st April 2012 and described above,, only the actual capex would be fully funded (through the TO RAV) and, therefore, any network modelling should take the "trued-up" level of investment into account with the consequence that the full set of Fleetwood investments should not be included from 1st April 2012 onwards.

As such, the TPCR3 arrangements incentivise a trade off between investment and buy-back risk, although it is not clear over what time period this should apply and how the risk should be treated after the 2012 "truing-up".

National Grid notes that Ofgem believes that a deficiency in the credit arrangements, as set out in the Uniform Network Code (UNC), has been identified. While National Grid does not consider that this is of relevance to the existence or determination of an IAE, or the issues raised in Centrica Energy's notice, National Grid would like to point out that it has raised a number of UNC Modification Proposals to address Ofgem's credit concerns which ultimately were not implemented after industry consideration. It is also worth noting that as part of the development of Modification proposal 500 there was extensive debate regarding the period over which credit should be provided. Some Shippers felt that significant amounts of credit should apply but due to the costs of providing such levels of credit, the industry concern was that this could act as a barrier to entry, and hence 12 months was the period proposed under Modification 500. National Grid is seeking to address concerns through the UNC Modification Proposal 0350. Modification Proposal 0350 would stop capacity rights lapsing, in the event that security was not put in place, and therefore this may ultimately lead to the termination of a shipper in the event that invoices were not paid.