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Dear Sonia

Initial proposals on interim incentive schemes supporting the offtake arrangements

NGT welcomes the opportunity to respond to this consultation on the interim incentive schemes associated with the offtake arrangements. This response is on behalf of the distribution business; the transmission business will be replying separately.

Given that the interim incentive scheme is leading up to the enduring incentive scheme, we agree that it is desirable to smooth the transition by minimising the differences between the two schemes. In particular it is important that the two schemes are consistent in the behaviour that they promote.

Supply and Demand Balance of NTS Exit Capacity

The design of the incentive scheme should be considered in the light of the underlying supply and demand equation. On the supply side, we note that Ofgem proposes that the NTS be required to meet requests for incremental exit capacity on an unconstrained basis with no allowance for buy-back costs. From this we understand that NTS offtake capacity is unlikely to be a scarce commodity during the interim incentive scheme. Turning to the demand side, it is clear that DNs will wish to secure exit capacity rights to cover forecast 1 in 20 demand for each year. Whilst moving above this level by a small amount will provide the comfort of a safety margin, even without an incentive scheme there is no benefit to a DN in requesting excessive levels of capacity that they have no expectation of using. This can be considered from the point of view of both primary exit capacity and flow flexibility:

- Primary Capacity: The only benefit to a DN in acquiring surplus NTS exit capacity at an offtake is to guard against unexpected load growth. Given that extra capacity can be acquired at any time, if there is any financial incentive the DN will wait until the requirement is certain before requesting the capacity.
- Flow Flexibility: In principle a DN has an incentive to increase its holding of flow flexibility and save costs by, for instance, decommissioning gas holders. However, a DN can only adopt this approach if it is confident of the price at which the required flow flexibility can be secured in the long term under the enduring arrangements.

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It is worth noting all rights for gas year 2008 will be made available under the enduring regime, so there are no long term "property rights" associated with securing additional rights under the interim arrangements. From this analysis, there is unlikely to be a shortage of NTS exit capacity rights during the period of the regime, combined with little motivation for the DNs to significantly over book, suggesting that the incentive need not be strong to check the tendency to over book.

Objectives of the Proposed Scheme

The objectives of the scheme are given as to "provide the DNs with an incentive to operate in a manner consistent with customers' interests" and to "mitigate a potentially rational tendency for the DNs to overbook". The latter point is on the basis that "DN shippers would bear the full cost of all additional NTS offtake rights requested by the DNs". Our understanding of the scheme is that there is no linkage between the volumes of DN exit capacity booked by Shippers and NTS offtake capacity held by DNs. Thus Shippers would only be liable for the NTS exit charges associated with their DN exit capacity, and not additional capacity requested unilaterally by the DN. We believe that this limitation to the Shippers' liability supports the case for mild incentives being sufficient to achieve the desired objective of the scheme.

Operation of the Scheme

Under the proposed scheme, a DN is free to request additional exit capacity from the NTS. This could happen either in response to an additional request for exit from a Shipper or because the DN believes that demand is rising in a way that Shippers are not reflecting in their exit bookings. Setting aside for the moment cash-flows associated with the incentive scheme, in the former case the DN Shippers will pay extra exit charges to the DN for the exit capacity, but as the DN has a predetermined allowed revenue, this money will be returned to Shippers the following year. In the latter case, no additional payments are made and the DN is cost neutral. Hence, ignoring the effect of the incentive scheme, the DN is cost neutral in both cases. The action of the incentive scheme is then to impose a charge on the DN for the extra NTS exit capacity booked.

The incentive scheme therefore has the following properties:

- An exposure for DNs to 1 in 20 demands increasing above the levels currently forecast. In principle we believe that the incentive scheme should respond to how efficiently the DN is operating and not penalise the DN because of unanticipated demand growth. Accordingly, we would argue strongly for the target to be subject to a growth term to allow for unanticipated demand growth. One approach would be to increase the scheme target by the weighted average price of NTS offtake capacity for each unit increase in 1 in 20 demand.
- An exposure to changes in the price of NTS exit capacity that the DN is not in a position to influence.
- As the scheme excludes the "forgone revenue" associated with interruption, it will encourage DNs to seek more interruptible capacity and hence reduce the volume of offtake capacity required. This appears perverse at a time when the NTS is signalling that there is sufficient exit capacity available.

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- As the costs of offtake capacity and flow flexibility are expected to vary by a factor of a hundred between Scotland at one extreme and the South of England at the other, the setting of caps/collars at a fixed percentage of target will result in widely differing risk reward profiles for different DNs. In setting up a regime of comparative regulation, it will be helpful to minimise the number of inter DN differences that need to be considered. This could be achieved by using the alternative approach suggested on page four of this response.

Pricing of Flow Flexibility

The consultation proposes three methodologies for pricing flow flexibility based on: NTS exit charges, the incremental cost of laying new pipe to provide storage and the price of providing storage within the DN. As no additional NTS investment will be possible within the duration of the scheme, DNs will only be able to access existing flow-flexibility. Hence, the cost to the NTS of storage is a sunk cost (indeed the storage capacity is a by-product: the NTS has not generally invested specifically to provide storage) and, so long as capacity is available on the NTS, a marginal charge of zero is appropriate for the interim. Using a higher value runs the risk of triggering investment in the DN (where that may be achieved in the time scale of the scheme) to provide storage that is already available at negligible cost on the NTS. The long term implications of a zero price are not a cause for concern, as the enduring scheme will be introduced in 2008.

Incentive to Reduce Bookings Held

In several places the text refers to DNs requesting additional NTS exit capacity without making clear that DNs can also return surplus rights to the NTS. It is important that a DN with rights that it does not need, for example following the closure of a large load, has an incentive to return the rights to the NTS so that they can be made available to another user who may be facing a shortage. This can be achieved by setting up the incentive scheme to credit the DN for capacity returned to the NTS as well as recording the costs of incremental capacity.

Scope of the Scheme: Exclusion of Forgone Revenue

The incentive scheme as proposed covers:

- Cost of NTS exit capacity
- Cost of Flow-Flexibility
- Cost of greater than 15 day interruption of DN connectees

This appears to omit the forgone revenue associated with interruptible capacity (or the corresponding costs in any reformed regime for DN interruption) which is necessary to create an incentive on the DN to trade off between the costs of additional NTS exit capacity and the full costs of interruption. As described above, excluding the forgone revenue element provides an incentive to increase the volume of interruptible capacity in order to reduce NTS exit capacity and receive a payment from the incentive scheme.

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Furthermore, by the same reasoning, should existing interruptible customers choose to go firm, the incentive scheme would reflect the increased volume of offtake capacity rights, but not the associated reduction in forgone revenue, and the local DN would be disadvantaged.

Detailed Points concerning Caps/Collars and Sharing Factors

We note that on the NTS buy-back and interruptions incentive the caps/collars and sharing factors have been set such that the incentivised range extends beyond the range that Ofgem indicate as a likely out-turn, in particular the cap cannot be achieved even if no costs are incurred at all. It would seem logical to set the caps and collars such that they bite at the extremities of the likely range of the out-turn. Thus the gas transporter's exposure is limited to the range of out-turn that Ofgem has identified as being plausible.

Unlike the recent consultation on the enduring incentive scheme, this consultation does not explicitly discuss how costs can be covered by an incentive scheme in two ways:

- Directly. The costs are included in the scheme out-turn that is then compared to the target and the resultant incentive payment/charge is calculated
- Indirectly. The costs are excluded from the out-turn and hence have no impact upon the incentive payment/charge. However, the DN can then use part of the incentive payment to fund the costs

However, the issue is implicit in the proposals. As with the enduring incentive, we propose that all the costs of interruption together with any investment costs incurred should be included directly. In this way a lower sharing factor can be chosen without risking distortion between the different approaches of booking extra capacity, greater use of interruption and investment in the DN. Indeed, we believe that a much lower sharing factor of the order of 5% would be sufficient to overcome the weak incentive to over book.

Interruption

Throughout this response we are assuming that the interruption arrangements introduced in 2006 will include fees for both being available to interrupt and for actually being interrupted. As a point of detail, section 3.17 refers to the NTS requesting to "turn-down" demand at an offtake. We understand that this refers to a request for DN interruption to relieve an NTS transportation constraint or for supply/demand purposes and that a cost sharing mechanism would be used to allocate costs between the NTS and DN.

Duration

We support the proposed duration of the interim scheme, namely from Hivedown until the enduring arrangements become active in real time in October 2008.

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Alternative Suggestion

It may be worth considering an alternative rule based approach. Under this regime DNs would be free to request any level of exit capacity at an offtake up to the level that they have booked in the long-term auctions for 2008. This provides a simple way of containing any tendency to over book and sets the ceiling at a level chosen by the DN concerned.

Summary

To summarise, we believe that there are four issues that are key to achieving the objectives of the incentive scheme:

- The proposed scheme exposes the DNs to unanticipated demand growth. This exposure can be removed by introducing a “load growth” correction into the target. One approach would be to increase the scheme target by the weighted average price of NTS exit capacity for each unit increase in 1 in 20 demands.
- There is a bias in favour of increasing the volume of interruptible capacity in the DNs. This can be overcome by including the forgone revenue (or fixed cost element) of interruption in the incentive scheme
- A DN has only a weak incentive to over book, which can be overcome using a low sharing factor.
- The proposed prices for flow-flexibility greatly overstate the cost to the NTS of providing the service. This creates the risk of DN investing to provide capacity rather than using the existing capacity on the NTS. Adopting a zero price for Flow-Flexibility in the interim would prevent this.

I trust that you find the above comments helpful in developing these incentive schemes. If you would like to discuss any of the points raised, please do not hesitate to contact me.

Yours sincerely

By E-Mail

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