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5 April 2005

Dear Sonia

NGT transmission business response to Ofgem's initial proposals on interim incentive schemes supporting the offtake arrangements

Please find attached a copy of the National Grid Transco transmission business response to Ofgem's initial proposals on interim incentive schemes supporting the offtake arrangements.

As ever I would be happy to discuss any elements of the response with you or members of your team.

Yours sincerely

By e-mail

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NGT transmission business response to Ofgem's initial proposals on interim incentive schemes supporting the offtake arrangements

Executive Summary

We welcome the opportunity to respond to Ofgem's, initial proposals on the interim incentive schemes supporting the offtake arrangements. This response is written on behalf of the NGT transmission business.

We are supportive of Ofgem's general approach of retaining most aspects of the current NTS exit incentive scheme. This would seem wholly consistent with the proposals that the interim offtake arrangements should, to a large extent, be based upon existing arrangements. Our main comments therefore relate to the new elements of the proposed incentive scheme, namely the proposed establishment of a "buy-back facility" and the new targets that are proposed for the period 2007/08 and 2008/09. These two elements are covered in the first two sections below.

Having considered our response we would welcome further discussions with Ofgem, to turn these initial proposals into Final Proposals that would ultimately provide Transco with the correct balance between risk and reward. In relation to the structure of this response we have provided detailed answers to each of the questions in relation to the NTS raised by Ofgem in Chapter 5 of their initial proposals document.

The proposed form, scope and duration of the NTS incentive scheme

We support Ofgem's proposal of retaining the scope and form of the NTS incentives for the interim period. This would seem wholly consistent with the proposals that the interim offtake arrangements should, to a large extent, be based upon existing arrangements. We recognise that the current incentive schemes are only specified through to the end of the current price control period (i.e up to 2006/07) and therefore there is a decision to be made regarding the timing of setting the parameters for 2007/8 and 2008/9. In the document, Ofgem states that it believes that the incentives should be set at this point in time for the further two years (2007/8 and 2008/9). Ofgem considers this necessary in order to give the NTS a degree of certainty as to the form of the incentives that it will face for the duration of the interim period.

Whilst in principle we are happy to consider parameters for 2007/8 and 2008/9, we believe that in setting the parameters for this period, allowance will need to be made for additional uncertainties which may exist by setting them now rather than at the next price control. In particular we believe that the lower ranges contained in the parameters for constrained LNG do not adequately take into account the uncertainties that exist in constrained LNG at this moment in time. Whilst we are happy to work with Ofgem to agree suitable targets for the parameters for 2007/8 and 2008/9 we do not believe that this would be a requirement for Network Sales to proceed.

The proposed introduction of a buy-back element to the NTS interim incentive arrangements

We note that Ofgem proposes to retain most of the current exit incentive scheme in the interim, but also to establish a "buy-back" facility, recognising that in the interim arrangements, NTS connectees will have unconstrained access to NTS exit capacity subject to statutory and licence obligations on Transco. We note that having established a

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"buy-back facility", Ofgem proposes that the target for the buy-back element of this incentive is set at zero for each year of the interim period. This implies that Ofgem does not anticipate Transco being required to undertake any buy back of capacity rights in the interim period.

In relation to meeting the 1 in 20 firm capacity requirements for the NTS in the interim period (which includes anticipated growth), we believe that these requirements can be satisfied without any need for the buying back of capacity. It should be recognised, however, that there are a small number of cases, where interruptible customers may choose to go firm, where buy-back costs may be incurred. We acknowledge that it would be difficult to set an appropriate buy-back fund, given both the uncertainty and likelihood of the triggering events, and it is feasible that no costs will be incurred. However, as no allowance has been made for these potential events in the setting of the targets, we believe that it would be more appropriate for any costs incurred as a result of these events to be covered via an income adjusting event. This would seem reasonable if the NTS had been obliged to release the capacity and had done so efficiently.

The proposed options for parameters for the buy-back and greater than 15-day interruption incentive

In relation to the parameters and proposed cap for the buy-back and interruption incentive, we do not believe that the upside sharing factors for this scheme are appropriate. Under either of options 1 and 2 proposed by Ofgem, it is not possible to achieve the cap within the scheme, as there are no revenues feeding into the scheme, only costs incurred. This means that, were no costs to be incurred for buy-back or greater than 15-day interruption, the maximum Transco could earn through the proposed scheme would be either £1.27m (under Option 1) or £1.19m (under Option 2) - (ie 80% and 75% of the cap value of £1.59m respectively). As a matter of principle we do not believe it is appropriate to set incentive parameters where the cap is unattainable. We therefore believe that an upside sharing factor of 100% would be more appropriate, as it would then enable the cap level to be achieved.

In relation to the parameters and the proposed collar, in paragraph 4.19, Ofgem suggest a potential figure of between £5m and £7m for potential buy-back costs. Based on the low end of Ofgem's cost range (£5m outturn), and where there are no costs incurred for the plus 15 day interruption payments, Ofgem has put forward proposals with two options where Transco would incur a loss (£2.6m under option 1 and £1.7m under option 2). Whilst we acknowledge that it would be difficult to set an appropriate buy-back fund, given both the uncertainty and likelihood of the triggering events, and it is feasible that no costs will be incurred, the options appear unattractive. As mentioned earlier as no allowance has been made for these potential events in the setting of the targets, we believe that it would be more appropriate for any costs incurred as a result of these events to be covered via an income adjusting event. This would seem reasonable if the NTS had been obliged to release the capacity and had done so efficiently.

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The proposed options for parameters for the charges foregone and exit investment incentive

If Ofgem believes that the targets need to be set for the formula years 2007/8 and 2008/9, at this point in time, we believe that Ofgem's proposed "Option 2 revision" would be the most appropriate way forward. In our view this would represent the only feasible estimate, at this point in time, of the likely level of the estimate of charges foregone, as it is based on the current proposed level of exit charges and the latest forecast levels of interruptible exit capacity. Given knowledge of this information there seems no merit in merely rolling over the existing targets (ie Option 1).

The most appropriate reference price for NTS offtake (flexibility) capacity;

We believe that the reference price should, in theory, represent the incremental price of providing an additional unit of flow flexibility. If this is practical in the interim period we would support this option (ie option 2 in the consultation document). This option would incentivise the DN not to request additional flow flexibility from the NTS if there was a cheaper alternative of investing in their own Network.

We believe the use of the NTS exit charges (option 1) should only be used if the other options are not deemed to be practical in the interim period. It needs to be recognised that if the NTS exit charges were used as a reference price then perverse incentives could arise. As highlighted in the consultation document where exit prices are low (eg Scotland), DN's may have an incentive to increase their use of flexibility and reduce directly substitutable activities. Clearly under this scenario investment may be required on the NTS that was more expensive than the alternative DN investment.

We believe that further consideration is required on the setting of the appropriate reference price before publication of the Final proposals document.

We also note that within the document Ofgem indicates that DNs could request incremental offtake capacity but our understanding of the business rules was that DNs could also request less offtake capacity.

The proposed form of the CLNG incentive

The proposed form of the CLNG incentive is a continuation of that which presently exists and with which we are comfortable. However, we are unsure of the need to set CLNG targets now as part of the interim incentives given that the years for which targets have been proposed do not fall within the present price control period. We are, however, happy to work with Ofgem to agree suitable targets for 2007/8 and 2008/9

As for the targets that have been proposed we recognise that the lower value is based on assertions that firstly, possible substitutes for services from constrained LNG storage facilities exist and secondly, that these substitutes are expected to be flowing at their maximum rate on the days when CLNG would otherwise be required.

Whilst flows from storage may be reasonably expected to occur on peak days, the issue for Transco NTS is whether this can be guaranteed. Transco NTS believes that in the absence of a contract to ensure that any substitute will flow at its maximum rate (or any other contracted rate) then there can be no guarantees that these essential flows would

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voluntarily occur from such substitutes on or close to peak conditions. If these flows cannot be guaranteed then in effect Transco NTS would be relying on a probabilistic assessment of the likely flows from substitute facilities. Such probabilistic assessments implicitly include a probability that such substitutes would therefore not be flowing at the required rate voluntarily, which, ex-post, would be difficult for Transco to demonstrate that it had satisfied its licence obligations and safety case.

We acknowledge that the presence of considerable diversity reduces, in aggregate, the probability of not achieving the required network effect in the absence of a suitable contract; however, it is Transco's opinion that the levels of diversity from appropriate local substitutes for this effect to materialise simply do not exist for the locations in question. Transco therefore believes that the requisite levels of flow from substitute sites can only be secured via appropriate contracts, similar in construct and therefore cost as CLNG services.

For this reason Transco NTS believes that the higher target cost value is the only appropriate option as this reflects Transco's assessment of the volumes of services that would be needed to ensure it is able to meet Standard Condition 16 of its GT Licence. Transco could then procure the appropriate level of services from those suppliers in the market.

DN Arrangements

We would support Ofgem's objective that the proposed interim DN incentive scheme ensures that the interface between the NTS and the DNs is operated in a manner consistent with GT statutory duties and licence obligations. In particular we would be keen to ensure that the arrangements incentivise the DNs to meet their 1 in 20 obligation in an efficient manner, given the nature of the interim offtake arrangements. We would therefore support DN incentive arrangements which incentivise the DNs not to overbook either capacity or flow flexibility.

Conclusion

To conclude we are supportive of Ofgem's general approach of retaining most aspects of the current NTS exit incentive scheme. This would seem wholly consistent with the proposals that the interim offtake arrangements should, to a large extent, be based upon existing arrangements. Our main comments have related to the new elements of the proposed incentive scheme, namely the proposed establishment of a "buy-back facility" and new targets that are required for the period 2007/08 and 2008/09.

Having considered our response we would welcome further discussions with Ofgem, to turn these initial proposals into Final Proposals that would ultimately provide Transco with the correct balance between risk and reward.