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Dear Sonia

**DN Sales – Initial Proposals on Interim Incentive Schemes Supporting The Offtake Arrangements.**

Thank you for the invitation to comment on the above consultation. In providing our response, we have followed the order of the consultation document.

<u>NTS Interim Incentive</u>

We support Ofgem's approach to preserve, as far as possible, the existing NTS exit incentive arrangements. However, in recognition that the interim offtake arrangements will require NGT to make NTS offtake rights available on an unconstrained basis, we agree that a new NTS exit capacity buyback incentive will be required.

Furthermore, since it is envisaged that the interim arrangements will continue until 1 October 2008, it would seem appropriate at this stage to introduce target parameters up to that date. We assume, therefore that Ofgem's proposals for incentive targets for the year 08/09 would need to be pro-rated in some way to reflect the fact that they will only be relevant for the first six months of that year.

**a) Buy back and greater than 15 day interruption incentive**

It is interesting to note that NGT has identified that, other than for a small number of cases, the NTS would have sufficient spare capacity to accommodate all requests from NTS direct connects moving from being interruptible to firm. We question why, therefore, this level of capacity has not been included in the existing baseline capacities. Nevertheless, based on this assessment and the current baselines we agree with Ofgem's view that the target costs of the buyback incentive should be set to zero.

Furthermore, NGT's assessment that there is sufficient capacity should be reflected when setting the long term exit capacity baselines and the future buyback incentive. Clearly, this would also mean that any "incremental" capacity released by NGT during the interim arrangements would be included in the enduring baseline. We note that this view is not shared by NGT. Rather, NGT has stated in its interim IExCR methodology that any interim incremental capacity would be "wiped clean" at the end of the interim period. In our view this would be inappropriate and would in, all likelihood, lead to an inappropriate reward of NTS incentive revenue in the longer term.

Turning now to the greater than fifteen (> 15) day curtailment incentive, we agree that the existing targets should be retained with new targets being set for 07/08 and 08/09. However, based on the above discussion in respect of the likelihood of buyback NGT's exposure to the > 15 day incentive is likely to be minimal and this should be reflected in the scheme parameters.

**b) Constrained LNG incentive**.

Given NGT's ownership of the LNG storage facilities, we agree with Ofgem that the existing parameters should be retained. We would expect delivery of gas from other storage sites on 1 in 20 peak days and therefore would suggest that the lower target number would be appropriate.

**c) Charges forgone incentive and exit investment incentive**.

NGT's statements in respect of their ability to make all existing interruptible customers firm without there being any risk of buy back would suggest that there is already "spare" capacity available on the NTS. We would therefore support the rollover of the 06/07 targets for years 07/08 and 08/09 and a retention of the other existing parameters as suggested by Ofgem.

<u>DN Interim Incentive</u>

We disagree with Ofgem's assumption that unless there is an explicit incentive scheme, DNs will have a tendency to overbook NTS capacity. Following the sales process, DNs and the NTS will continue to be subject to the normal price control mechanism. Therefore, to the extent that a DN's request for capacity incurs NTS expenditure (to be recovered from DN shippers) this additional expense would be subject to the normal price control checks and balances to ensure that the cost has been efficiently incurred.

**a) Scope**

Notwithstanding the above, we believe that the interim incentive scheme should be simple and, therefore, we support Ofgem's proposals for a single incentive mechanism that would include a DN's request for additional NTS capacity over and above that allocated to it initially and the use of interruption. It would also seem appropriate that the incentive should apply for the duration of the interim arrangements although, clearly, if the DN exit arrangements are reformed during this time, it is likely that the offtake incentive regime would need to be reviewed to ensure consistency.

**b) Form**

In setting the DN performance targets it is essential to ensure that the initial allocation of NTS exit capacity for both flat capacity and flexibility reflect the existing parameters of the DN offtake points. That is, they should accurately reflect the way in which the NTS offtake points have been planned to operate under NGT's common ownership.

Capacity Volumes. The base allocations of flat capacity and flexibility capacity for the interim period set out in Appendix 2 were based on figures provided by NGT and which were included in the initial Capacity Offtake Statements associated with the UNC consultation. We understand that these statements contained a number of errors which, we believe, have now been addressed and, therefore, the base allocations will need to be amended accordingly.

However, we believe that there are a number of other issues that must be addressed:

1. The first relates to how the allocated capacity volumes which are set out in the licence and which will drive the target and performance measures are adjusted year on year. For example, if in year two of the incentive scheme a DN books additional capacity and, as a consequence, pays the relevant "penalty", we believe that the additional capacity should be added to the subsequent year's capacity allocations, otherwise the DN would be penalised year on year for the same incremental capacity.

2. We are concerned that under this mechanism, it is assumed that any request for additional capacity is "inefficient" and must therefore be penalised. We do not believe that this is appropriate. A DN has a duty to connect new customers and to maintain the appropriate security of supply standards. We do not therefore believe that a DN should be "penalised" under the incentive mechanism for meeting unexpected increases in demand. Such a demand may result from a large interruptible load requesting to become firm. Therefore, we believe that there must be a mechanism that would allow the DN to book capacity to meet "unexpected" demand growth without being penalised. This could be achieved by an ex-post adjustment to the targets to reflect differences between outturn demand and the forecast at the time targets were set.

Capacity Price. It is important to establish that the incentive calculations do not inappropriately expose the DN to fluctuations in NTS exit charges. Therefore, target and performance calculations must be determined using a common price.

We agree that it would be appropriate to base the flat capacity price element of the incentive on the prevailing outturn price of NTS exit capacity as set out in NGT's charging statement.

Ofgem has proposed a number of alternatives for determining the price for the flexibility element of the incentive scheme. In the interest of simplicity and in recognition of the time constraint associated with the introduction of the proposed incentive, we believe that the first option is probably the most pragmatic solution to adopt. Nevertheless, this methodology is somewhat at odds with the flexibility product which, according to NGT, is unrelated to the flat capacity product and therefore, it would be inappropriate to adopt this pricing approach in the longer term.

Cost of >15 day interruption. Ofgem has provided the target cost parameters for > 15 day interruption in Appendix 3. We would have expected these to replicate those that have recently been removed from the NTS incentive scheme for the years 2005/06 and 2006/07. That is, in aggregate we would have expected the DN incentive target to equal £1.59m for 2005/06 (not £1.55m) and £1.68m for 2006/07 (not £1.63m). We are also unsure how the aggregate sums have been divided between the eight DNs or how the target costs have been calculated for the additional two years.

Caps, collars and sharing factors. We agree that the incentive scheme parameters should be symmetrical. However, given that this is a new incentive scheme, based on numbers provided by Transco, we believe that the DNs should not be exposed to the extent set out in table 4.7. We consider that the particular caps and collars set out in the document are in excess of the levels of exposure necessary to encourage efficient procurement of exit capacity. We also note that there are regulatory precedents for limiting licencees exposure to new incentive schemes (for example, the electricity IIP scheme resulted in no reward/ penalty for the first few years). Against this background, we consider that a cap and collar of, say, 2% would be more appropriate. This would not of course preclude a higher exposure in the enduring arrangements if that was deemed appropriate.

We hope that you will find the above comments useful. If you would like to discuss any of the points we have raised in more detail, please give me a call.

Yours sincerely

Rob McDonald
**Director of Regulation**