

Mark Feather
Office of Gas and Electricity Markets
9 Millbank
London
SW1P 3GE

Head Office
Inveralmond House
200 Dunkeld Road
Perth
PH1 3AQ

Our Reference:
Your Reference:

Telephone: 01738 456400
Facsimile: 01738 456415
email:

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Dear Mark

Notice Under S23(3) of the Gas Act 1986 to modify Transco NTS Special Condition C8B(14)(5)(f)(ii)(a) in response to UNC Modification Proposal 0043.

We are writing in response to the above Notice and hope that you will find our comments helpful.

If implemented, we understand that the purpose of the licence modification would be, in essence, to allow Transco NTS to be exempt from its obligation to use all reasonable endeavours to offer for sale obligated NTS entry capacity. We also understand that the Authority would only direct the implementation of the licence modification in the event that UNC Modification Proposal 0043 (Mod 0043) is approved. That is, the two processes are inextricably linked and, therefore, in considering our response to the above Notice, we would also ask that you take into account the comments we made in our letter addressed to you dated 7 September.

In our view, implementation of these two proposals would enable NGT to effectively circumvent the NTS SO incentive scheme in a way that was not envisaged at the time the price control was implemented in 2002. That is, it would provide Transco NTS with the ability to be granted a “derogation” from the licence obligation to release 100% of obligated NTS entry capacity (i.e. baseline capacity *and* any unsold obligated incremental capacity).

We do not consider this to be appropriate given the following points:

1. The determination of NTS entry capacity baselines was a fundamental building block of the existing NTS entry capacity incentive regime. The numbers that were inserted into the licence were consulted upon extensively and accepted by Transco as part of the NTS price control and formed the basis of TO allowed revenue. We do not therefore believe that it is appropriate to potentially change these numbers mid-price

control (which is what, in effect, would happen if Transco were to be granted a “derogation” by virtue of this proposed licence change).

2. In addition to the above, the NTS SO incentive scheme introduced an element of buyback that was again consulted on and accepted by Transco as part of the price control package. The buyback amount was considered to be appropriate and proportionate to a) the baseline quantities and b) the potential risk of that baseline capacity not being physically available. It is therefore clear that any change in Transco’s obligations to provide capacity should result in a reduction in allowed revenues for that function.
3. Under the existing incentive scheme, the decision about whether to release obligated incremental capacity lies with Transco once it has applied the economic tests set out in its IECR methodology statement. Again, the regime that was introduced as part of the NTS SO incentive regime and accepted by Transco was based upon Transco’s assessment of the economic test and the rate of return that would be allowed on incremental capacity. Both of these reflected the risk/reward associated with the release of incremental capacity. A key principle of this risk/reward was that once the capacity has been designated as obligated, it remained that way.
4. We are concerned that substantial changes to the methodology for making capacity available will raise new risks for market participants.

In anticipation of the implementation of Mod 0043 and the associated licence change, we note that Transco is currently seeking views on limiting the release for sale of unsold obligated NTS entry capacity at Milford Haven. While we recognise that this request does not apply to baseline entry capacity, it does however relate to the release of unsold incremental obligated NTS entry capacity at Milford Haven that only recently Transco has committed to make available having applied the relevant economic tests. In other words, it would appear to us that Transco now believes it made the “wrong call” under its NTS SO incentive scheme when it considered the release of obligated incremental capacity at this location.

In our view, therefore, the underlying rationale of risk/reward associated with the incentive scheme and the economic tests that were applicable when Transco made the investment decisions at Milford Haven should prevail for that capacity. To the extent that Transco believes that the economic tests it has applied to date are inappropriate, Transco has the ability to consult upon this methodology with a view to changing it going forward. Likewise, to the extent that Transco believes the risk to which it is now exposed from decisions it has already taken is unacceptable for a regulated network business, we would expect Transco to enter into negotiations with Ofgem during the coming price control review. We also understand that given the timescales involved, Transco has not yet been exposed to any economic loss from its decision to release this capacity at Milford Haven.

Notwithstanding the above comments, to the extent that Ofgem does approve Mod 0043, we believe that the proposed change to the NTS licence would be essential to ensure that

there is sufficient regulatory oversight of any desire by Transco to limit the amount of obligated NTS entry capacity it would offer for sale. We also believe that there should be a fundamental review of the effectiveness of the NTS SO incentive scheme as part of the price control review process with a view to implementing a far simpler, less complex scheme going forward.

I hope that you will find the above comments useful. Please give me a call if you would like to discuss any of the points we have made in more detail.

Yours sincerely

Rob McDonald
Director of Regulation