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National Grid NTS and other
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6 June 2006

Dear Colleague,

**Proposed revisions to the Incremental Entry Capacity Release ("IECR")
Methodology Statement to include Investment Cost Methodology**

Ofgem¹ has considered the issues in the IECR annual review consultation report submitted by National Grid National Transmission System (NTS) on 11 May 2006 in respect of its proposed revisions to the IECR methodology statement. Having regard to the principal objective and statutory duties of the Authority², and for the reasons set out in this letter, Ofgem has decided that it will give consent to the proposed revisions pursuant to Special Condition C15(7)(c) of National Grid Gas plc's ("NGG") NTS Gas Transporter's Licence.

This letter outlines the background to NGG's consultation and gives the reasons for the decision.

Background to the consultation

On 6 April 2006 NGG initiated a consultation proposing a number of revisions to the IECR methodology statement to include the methodology used by NGG for calculating the investment costs for new pipelines, and substituting references to 'Transco' to that of 'National Grid'.

Respondents' views

NGG received one response to its consultation.

The respondent saw only limited value in the methodology as a predictive tool for any individual project arising out of auction commitments made at future Quarterly System Entry Capacity ("QSEC") auctions as the respondent felt it was reliant on past projects and the use of a single formula to estimate costs.

¹ Ofgem is the Office of the Gas and Electricity Markets Authority. The terms 'Ofgem' and 'the Authority' are used interchangeably in this letter.

² Set out in Section 4AA of the Gas Act 1986, as amended.

The respondent also wanted to have a correction factor in the formula and a process under the methodology that would allow the formula to be 'corrected' should successive applications of the methodology result in systematic bias in forecasting the investment costs compared to actual costs.

Ofgem's view

On 11 May 2006, following the close of National Grid NTS's consultation on the proposed revision of the IECR methodology statement, NGG submitted the IECR annual review consultation report to Ofgem consistent with the provisions of Special Condition C15(7)(b)(i). Ofgem notes that the revised IECR methodology statement provided has been submitted as required by Special Condition C15(7) and following consideration of the concerns raised by shippers in National Grid NTS's consultation process. We set out below our reasons for giving consent to the proposed revisions and views on the issues raised in the consultation responses.

Ofgem accepts the change in reference from 'Transco' to 'National Grid' as this reflects the unifying of the majority of operating businesses under the National Grid name, which took place in October 2005.

Ofgem welcomes the proposed publication of the Investment Cost Methodology in the IECR methodology statement as this allows for greater transparency of the decision process governing the release of incremental entry capacity. This should help Ofgem deliver its primary objective of protecting the interests of consumers through promoting effective competition.

Ofgem notes the issues raised by the respondent regarding the reliance on past projects and the use of a single formula in estimating investment costs. However, NGG supplied further details of the pipeline cost formula to Ofgem which show that the formula takes into account both actual costs of past projects and forecast costs of any future planned projects.

Ofgem also notes the further issue raised by the respondent over the inclusion of a correction factor in the formula to deal with any systematic bias in modelling investment costs. Similarly, the additional details provided on the pipeline cost formula to Ofgem suggest that the formula incorporates factors to correct for steel prices, construction costs and inflation.

Ofgem's decision

Following consideration of the documentation provided and having regard to the Authority's principal objective and statutory duties and for the reasons set out above, Ofgem has decided that it will give consent to the proposed revisions to the IECR methodology statement pursuant to Special Condition C15(7)(c).

Ofgem now expects to receive a submission for approval of the IECR methodology statement pursuant to Special Condition C15(2) and the audit report pursuant to Special Condition C15(3) from NGG before 1 July 2006.

Any proposals to revise the IECR methodology statement which may arise outside the annual review process, as described in Special Condition C15(7), such as the consultation

on setting Unit Cost Allowances (UCAs) for large new entry points³, can be made pursuant to Special Licence Condition C15(5).

If you wish to discuss any aspect of this letter, Richard Miller (telephone 0141 331 6013) would be pleased to assist.

Yours sincerely

Robert Hull
Director, Transmission

³ For further information on this read 'Adjusting National Grid's revenue allowances when large new entry points connect to the gas transmission system' published on www.ofgem.gov.uk on 29 March 2006