SO Incentives

National Grid Gas (NTS) Consultation on
Conclusions on Operating Margins Contestability
and
Initial Thoughts for Associated SO Incentive Arrangements

A note for the Gas Forum

September 2008

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Executive summary

The National Grid (NG) document is focused mainly on the issue of contestability with one section on the subject of the SO incentive for System Reserve (OM). TPA has not analysed the contestability content except where it has been necessary to understand the impact it may have on the incentive regime.

The key conclusions from our review of the OM incentive proposals are as follows.

- We do not at this stage believe that there is sufficient justification to remove any of the responsibility for determining and procuring OM from NG.
- The primary focus of any annual incentive should be to retain a cost target as the current primary incentive.
- A long term incentive could be beneficial in developing innovative OM services; however this should be structured in such a way as to encourage contestability. We believe that this could be achieved by setting an average unit cost target for OM services over a 3 to 5 year period, coupled with an annual volume target (reset annually) and an incentive to reduce total OM volume over that period. To avoid high costs in the short term a cap should be placed on the unit cost set at the highest NG LNG regulated price.
- It is too early to recommend what changes should be made to the regime to take account of the impact of contestability on the sharing of costs/benefits between NG and shippers.
- There is not sufficient evidence to enable any assessment to be made of changing the timings of the incentive year.

TPA has prepared a response to the specific questions raised by NG at the end of this paper.

Introduction

The consultation document produced by National Grid (NG) entitled "Conclusions on Operating Margins Contestability and Initial Thoughts for Associated SO Incentive Arrangements" primarily contains an assessment of the options for developing contestable services for Operating Margin provision. TPA Solutions has not been specifically asked to comment on this aspect of the consultation but has briefly reviewed the contents for anything of relevance to the OM Incentive questions.

We have focused our attention on the questions raised by NG with respect to the development of the SO Incentive. This note gives a brief description of the incentive consultation and provides some responses to the NG questions.

NG Consultation on OM Contestability

NG has presented in this document a substantial amount of material on different potential contestable OM sources which in summary are:-

Storage

LNG Importation

NTS Demand Side

DN Demand Side (including use of DN storage)

Offshore Supply and Interconnectors

NG does not envisage any barriers to entry or operational or contractual problems with storage facilities or LNG importation facilities that include storage. LNG importation facilities without storage are considered wholly unsuitable due to the fact that it would be highly unlikely that there happened to be a ship in dock when OM is needed.

For NTS demand side sources NG highlights several issues, mainly related to the impact on electricity supply, and which indicate that there may need to be substantial contractual constraints on service providers to NG unless the service is offered at locations where there are CCGTs with standby fuel or industrial sites.

For DN demand side sources the issues are similar to those for NTS connected load. There are concerns that DN's using their own storage to provide OM at a particular location could find that they have a problem the next day providing OM at the same location as they may not be able to refill their storage. This may constrain DNs ability to offer the service.

NG does not believe tenders for OM provision from interconnection facilities would be possible because of issues regarding the ability of interconnectors to provide the OM service independently of market conditions.

For Offshore Supply sources NG has concerns over the economic viability of sterilising headroom across a variety of supplies in order to secure diversity of OM supply. Also, the OM seller may not be able to guarantee on overall supply increase at a beach terminal, leading to questions over viability of this source.

There are other points made about how suitable certain sources are for orderly run-down given that some of these sources will have already been invoked in an emergency by the NEC.

One aspect of particular relevance to the incentive regime is the fact that NG has outlined options for the Procurement Strategy which suggests the possibility of different commencement dates and durations for OM contracts.

NG Consultation on OM Incentives

NG summarises its objectives of the consultation in this area as follows:

"The document looks at how best to incentivise OM Service procurement and how the incentive could be used to assist the aims of the OM contestability work. National Grid Gas seeks views on how best to incentivise the procurement of the OM Service going forward."

NG claims that there is a strong linkage between the OM Contestability work and the development of an enduring incentive regime that supports the key themes from the contestability work to be taken forward. NG believes that therefore it should continue to be incentivised to procure the OM Service in an efficient, economic and co-ordinated manner, but that the design of such incentives should be able to deal with the potential complexity and uncertainty that the contestability work might bring.

The stated objective of System Reserve (OM) incentive is to minimise the total cost (in terms of both volume procured and prices paid) of procuring Operating Margins Services to meet an Operating Margins Requirement.

This, NG states, acts primarily as a mechanism to allow NG to recover the efficiently incurred cost of procuring OM whilst also allowing a limited amount of scope for procurement innovation. The introduction of contestability is claimed to introduce uncertainty and hence a need to look in a broader sense at some of the issues surrounding OM procurement, before considering more detailed issues with the current arrangements.

NG states that the need to hold OM is partly linked to issues that NG has some influence over, such as physical events relating to NTS equipment and the topology of the NTS itself. But it is also linked to issues which NG has no direct influence over, such as offshore supply losses. NG poses the question whether NG's role in OM procurement should be all encompassing, or whether certain responsibilities should be shared.

NG raises the possibility that different parties could be made accountable for different requirements, because NG can only influence aspects within its control e.g. shippers determining and procuring their own requirements for supply losses, and DNs dealing with requirements for Orderly Rundown. On the latter NG also states that there have been some problems getting information from DNs with regard to orderly rundown requirements, and that a collaborative approach for the determination of requirements would be beneficial.

Overall, however, NG acknowledges that there remain benefits in adopting a co-ordinated approach to the procurement of OM, rather than dividing responsibilities.

NG concludes that rather than just incentivising the efficient procurement of OM to meet the forecast requirement, it might be appropriate to shift the focus of the incentive to more directly incentivise controllable elements that make up the overall OM requirement.

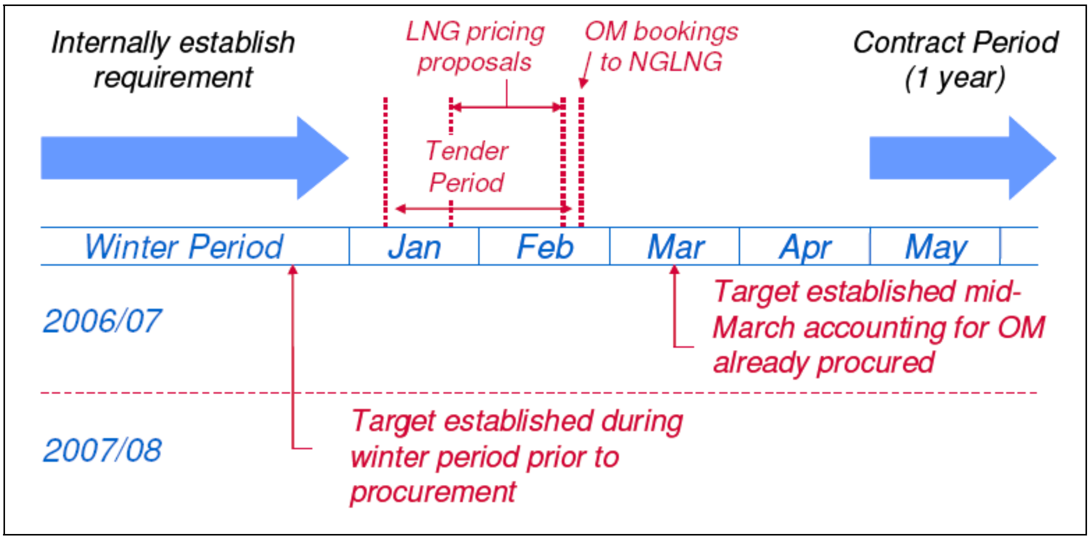
<u>Current Incentive Arrangements and Impact on Behaviour</u>

The current structure of the incentive is in two parts: - Holding Cost and Utilisation Costs. The Holding Cost incentive has a 100% sharing factor with no cap or collar with a current target cost of £20.54m. The Utilisation Cost incentive has a target of £0.27m with a collar of £0.5m; NG is permitted to recover actual costs over £0.5m where there have been significant OM utilisation events.

The current volume split between regulated (i.e. NG LNG storage) and non-regulated OM service sources is around 50:50 a fall from 2005 when it was 70:30.

With regard to NG's approach to procurement that the current arrangements dictate there are concerns raised by NG that there are inefficiencies that could be addressed.

The timetables in recent years have been as shown below.



The target for 2008/9 was set during the winter of 2007/8 prior to procurement and remained unchanged when finalised. This provided some scope for optimisation of bookings across different storage sites and providers.

NG states that the annual incentive period tends to favour existing OM providers who are familiar with the OM procurement process. NG is also incentivised to optimise the cost of re-profiling gas between storage facilities from one storage year to the next as a result of the overall holdings incentive, but there is also another barrier to overcome in that different facilities will only be used if the holding cost saving is greater than the re-profiling cost.

NG consider that the System Reserve Holding Cost Incentive effectively operates as 'allowed revenue' due to the 100% sharing factors against a close-to-incentive-start target setting mechanism rather than a procurement incentive in the wider sense. Therefore NG believes that it is questionable whether the current incentive structure drives the 'right' behaviour and gives sufficient scope for procurement innovation.

The use of a single annual tender as the main procurement mechanism for OM has not always delivered the most efficient prices. National Grid has gained significant price efficiencies over some of the submitted tenders through the use of other established procurement mechanisms, but no details are provided of the alternatives. NG should be requested to explain this statement in more detail.

NG summarises the key problems with the current mechanism as follows:-

- Lack of incentive to innovate - The combination of annual incentive duration and target setting overlapping with procurement timescales presents limited scope to vary from the current procurement mechanism to either pursue longer term deals or take advantage of earlier procurement opportunities
- No recognition of amount procured from non-NG LNG services – It's true that the volumes have shifted to non-NG LNG services but we believe that

this is primarily as a result of pressure from Ofgem and the change of use of Isle of Grain to an importation facility rather than a concerted effort by NG
- Uncertainty associated with contestability
- Misalignment between incentive/financial year (1st April to 31st March) and storage year (1st May to 30th April). Incidentally the publication of NG's volume requirements is set in the Network Code as being before the 1st March.

Options for a future incentive mechanism

NG identifies the following possibilities for development:

- Long term incentive – may allow greater innovation but may also lead to greater errors in requirements given that the longer term forecasts will have greater uncertainty. Drivers of cost could also change significantly over that period. It would require some form of adjusting mechanism and a revised sharing mechanism for incentive costs/benefits.
- Set incentive targets further ahead of the incentive start date - could drive innovation by allowing NG to take advantage of earlier procurement opportunities which may lead to more efficient procurement.
- Separate procurement of Orderly Rundown – this is claimed to be more efficient as it can only be procured from storage, where NG's expertise lies with respect to procurement. No other supporting evidence provided.
- Removal of LNG price regulation – justified on the grounds that more non-NG LNG procurement could allow deregulation and hence the introduction of revised incentive sharing arrangements with cap/collar.
- Revised incentive start date to allow more efficient purchasing – the commentary is inconclusive as it makes a case for changing to a storage year for storage services but this might conflict with creating more contestability if the providers offer services based on their own financial years which could be different to both start dates. Also adds complexity to the SO Incentive setting timetable.

A brief comment is made regarding the materiality of changes, which simply states that this is difficult to assess given the uncertainty surrounding the impact of contestability.

NG Questions and TPA Solutions Response

Below we provide responses to the questions raised by NG based on our analysis of the issues raised by this consultation:

Q8.1: Should National Grid Gas continue to be incentivised to assess and procure overall OM requirements on behalf of the industry?

NG has suggested that there may be a case for making different parties accountable for different requirements. NG also states that it has been having some problems getting information from DNs to support their Orderly Rundown requirements. We believe there are strong arguments against this approach from the safety point of view. Given that NG has overall responsibility for handling gas supply emergencies as the NEC, a fully co-ordinated approach managed by NG should be the most effective means of determining OM requirements irrespective of the final usage of OM. NG should also retain an incentive that minimises the cost of OM provision.

NG should be supported by shippers and DN's in developing appropriate levels of OM provision, by ensuring that NG are provided with the necessary information to allow accurate determination of the overall volume requirements.

Q8.2: What should the objective of the OM incentive be and what is the most appropriate parameter against which to measure performance?

In the absence of any information on how successful contestability will be in bringing prices down then the objective for this year at least should be to keep the primary incentive related to minimising the cost of the service.

Q8.3: How might incentive targets and structures be set to promote long-term cost management strategies, recognising the trade-off between the accuracy of the incentive target and the potential economic benefits of longer-term procurement?

If NG had a long term incentive to bring the cost down as opposed to meeting a total cost target each year this would permit the short term rises they expect might occur as contestability starts, providing over the longer term costs per unit of OM are managed and ideally reduced. On the evidence presented it would appear that it is likely that the NG imposed limitation on suitable sources to provide contestable services that prices for alternative options could be high in the short term. But to ensure that prices come down a simple long term arrangement may not be sufficient unless NG are prepared to relax the contractual commitments that may be imposed to ensure that the provision of some OM services doesn't create problems for NG elsewhere e.g. on the electricity system or other parts of the NTS.

As there may be a need to accommodate changes in volume drivers as well as cost drivers, an adjustment mechanism should be introduced, but the exact driver would need to be carefully selected to ensure continued control on total costs. An average unit cost target for OM provision over a period (say 3 to 5 years) combined with an annual volume target is a possible solution. To ensure that volumes don't get out of hand there should also be an incentive to encourage innovation in assessing the OM volumes.

There could be concerns with this approach that cost in some years could be substantially higher than other years but this could be addressed by placing a cap on the unit cost at say the highest NG LNG regulated unit cost.

Q8.4: How should the incentive develop to drive innovation and potentially promote the aims of the OM contestability work?

It is not clear from the NG consultation what the potential barriers are that could prevent competition developing. Are the regulated prices too low or is it the impact of the contractual commitments that NG would require from other service providers to achieve the same level of service as LNG? There is also no clear indication from the material provided as to how effective contestability will be.

We have outlined in our response to Q8.3 a proposed incentive regime. This proposal could also we believe drive innovation and support development of contestability.

The incentive should also be developed, as stated in our response to Q8.3 above, to encourage NG to be innovative with the way it produces the volume forecast. We fully understand the need to ensure a safe network but a simple cost incentive does not necessarily deliver any long term reductions in the amount of OM provided, should this be permitted by the NG Safety Case. As more information becomes available to shippers on real time flows then the shocks that may have generated an OM need are actually handled by the market.

NG has incentives within the current regime to improve demand forecasting and information provision. Both of these are there to reduce uncertainty in the market place and therefore it would seem appropriate to bolster these incentives with an OM incentive that encourages NG to re-examine the fundamentals behind the volume determination with the aim of minimising the total requirement. This should operate in conjunction with the incentive to reduce unit cost of OM provision as proposed above.

Q8.5: Should the incentive treat the procurement of the Orderly Rundown requirement differently from other OM requirements, given its storage-based nature?

This could be an unnecessary refinement if contestability fails to deliver any tangible economic benefits compared to the use of storage services. Separation could be reconsidered when contestability has been established. It is conceivable that by offering this option NG are seeking to establish contestability in an area where there would be more competition with NG LNG and hence would speed up the de-regulation of NG LNG prices. However it is debateable whether separation creates a better environment for contestability as NG will be tendering for services across their whole range of needs and focusing on one aspect does not appear to offer any significant benefits.

Q8.6: Should the incentive be designed to share risks and rewards between National Grid and Shippers (i.e. through sharing factors, caps and collars), should this be linked to the development of contestability and is there a contestability 'trigger' point where such arrangements should be introduced?

Ultimately risk and reward in this specific area should primarily rest with NG, until there is a range of different service providers.

In addition the impact that shippers have on OM volumes is minimal with NG having total control of the assumptions and modelling used to determine the volumes of OM needed for each category.

This is another area that should be revisited should contestability develop or should NG make another step change reduction in their bookings of NG LNG services or develop innovative means of determining OM requirements.

There is not sufficient information yet to establish an appropriate contestability trigger point.

Q8.7: Is the difference between the Storage Year and financial year significant enough to warrant changing the incentive start date potentially introducing accounting and reporting complexity into the arrangements?

NG has not been able to specify, in its assessment of this issue, the clear impact of any changes to incentive start date. It is therefore not possible to ascertain at this stage that there are any benefits from changing.