

Operating Margins Incentive Outcome of Consultation

National Grid
Gas Transmission

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Introduction

On 11 August 2017, National Grid issued a consultation on the potential re-introduction of a financial incentive for the cost of Operating Margins gas. These proposals were designed to help ensure that the costs customers pay for Operating Margins are kept to a minimum. We welcomed views from customers and interested stakeholders on whether the proposed scheme provided value for customers and was fair and effective.

The consultation closed on 8 September 2017, and three responses were received from Energy UK (who represent a number of large shippers, some of which are Operating Margins providers), RWE and Industrial and Commercial Shippers and Suppliers (ICoSS, a trade body). The three responses that we received were not supportive of the proposal. However, when the proposal was introduced at various forums prior to the release of the consultation document, we were encouraged by many customers' responses; we believed that they felt comfortable with the proposal as they were vocally supportive. We would have liked a larger response rate, and believe that three responses alone are not necessarily a true representation of the whole industry.

We have expanded on the main points raised in the customer responses below, and have taken the opportunity to further explain our justification for how the scheme concept was designed.

Our stance remains that financially incentivising this service is a positive approach; we feel that regimes should both recognise proactive good performance and encourage continued focus in order to keep the momentum of delivering continuous improvement.

We have however, acknowledged the lack of customer support for this scheme and following discussions with Ofgem in October 2017, have decided to postpone further consideration of the introduction of this scheme and instead review this as part of the RIIO-T2 process.

Respondents' Comments

Market conditions

One common theme was that respondents felt that market conditions predominantly affect prices and that National Grid's influence over this is indirect and highly uncertain. However, the respondents also acknowledged National Grid's role in achieving the recent cost reductions. One respondent stated that National Grid had achieved a good outcome; and another noted that National Grid has already widened the pool of potential providers, tailored services requirements and simplified contracts. This suggests that the respondents do recognise that National Grid has an important role to play in reducing costs.

We therefore do not agree that National Grid's influence is indirect and highly uncertain. We believe that one of the biggest factors that affect prices is the amount of competition within the market, and this is where National Grid can have a significant impact.

As highlighted in our Business Plan, total costs between 2015/16 and 2017/18 reduced by 49 percent, with 23 percent of this attributable to a decrease in volume. We have focussed on increasing tender participation for the OM Service. Since 2015/16, we have secured tenders from 10 new facilities, 9 new companies as well as offers from existing companies to extend the services that they already provide all of which has contributed to achieving a reduction in price for our customers.

We maintain that our hard work in encouraging competition needs to continue in order to drive down prices. We recognise that the conditions of the market do play a part, but we were also prepared to share the risk. It is worth noting that market prices also influence our performance against other incentives, such as Constraint Management, Residual Balancing and Shrinkage procurement.

Reputational incentive

The three respondents felt that the current reputational incentive is sufficient. One respondent questioned what more National Grid could do to engage the market and reduce costs than it already has.

As explained above, higher prices may return if investment isn't made to continue to sufficiently engage the market. We think that attracting new and retaining existing tenderers remains key to prevent a decrease in market competition.

Continuation of the reputational incentive will not provide such strong encouragement to the regulated business to drive further improvements in non-incentivised areas; we believed it was fair to be financially rewarded for our continued performance following our proactive initiative.

Volume changes

One respondent highlighted that the volume of Operating Margins we are required to buy varies from year to year. Whilst this is true, the design of the scheme meant that any cost increases as a result of a volume increase would be more limited for customers as National Grid shares the cost; National Grid was willing to share in both any risk or reward. National Grid reviews the methodology with the industry on a regular basis to ensure that the volume requirement is relevant.

The proposed scheme could have been designed to remove the volume variation but we deemed this unnecessary; one of our key principles was to keep the proposal as simple as possible.

Utilisation costs

One respondent highlighted that utilisation costs were included in previous incentives but not in this proposal.

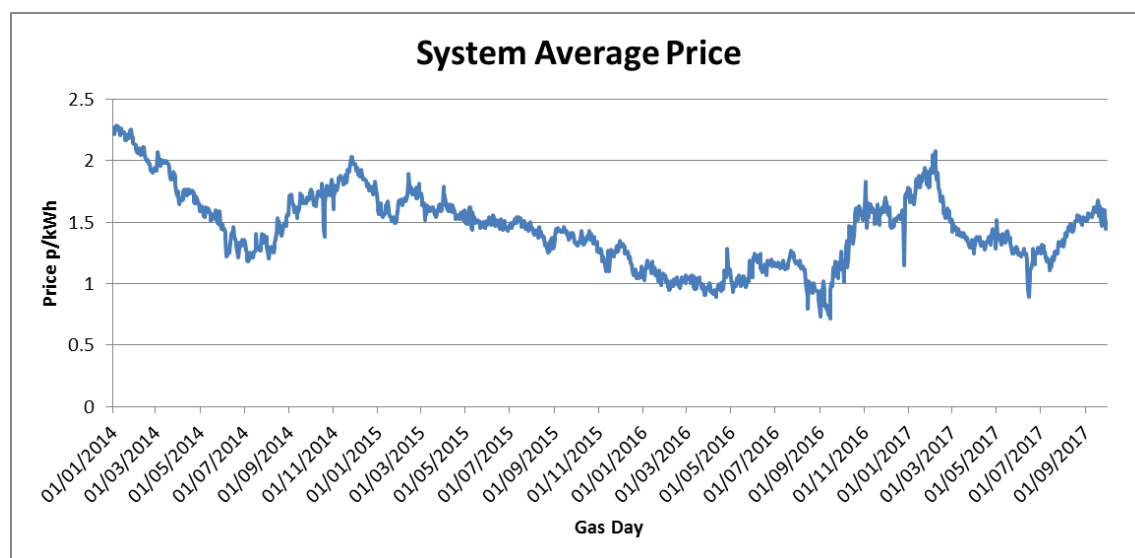
Further to the point made above, the intention of the scheme was to keep it straight forward. As explained in the Business Plan, we could have included the utilisation costs but we did not deem this appropriate given that the service is rarely used (and therefore costs actually incurring).

Wholesale gas market costs

One respondent suggested that the incentive was unfair given that the wholesale gas market costs are falling anyway. This incentive scheme design did not include the cost of buying and selling gas; it included the cost of storage only. There is some indirect impact of wholesale costs on storage but there is no reason to believe that this is falling.

It is true that the price of gas has declined, and did so quite noticeably during the first half of 2014. This is illustrated in Diagram 1 below.

Diagram 1: System Average Price for gas from January 2014 to September 2017



However, the prices have now increased again. Regardless of historic trend, it must be acknowledged that this was a forward looking incentive; we were not incentivising against a historical fall in price. The future prices of gas remain uncertain, albeit the forward prices are currently relatively flat.

Scheme parameters

One respondent questioned the rationale for the scheme parameters. We gave considerable thought into what these should be whilst creating the incentive proposal; our principles were based upon the relative levels of risk and reward, whilst comparing against existing incentive schemes and the previous financial incentive on Operating Margins to provide a benchmark. Our justifications for the scheme parameters were provided in detail in the Business Plan. We were happy to further consider the proposed scheme parameters.

National Grid proposing incentives

One respondent felt that a regulated business should not propose incentives. We disagree with this; we believe that regulated businesses should continually be looking for ways to deliver greater efficiency for customers, and it is reasonable for a regulated business to seek appropriate reward where it can demonstrate such benefits. Ultimately any decision as to whether an incentive should be introduced lies with Ofgem.

Conclusions

A great deal of good work has taken place in order to explore and shape a potential Operating Margins scheme and we do believe that the original design proposed was viable and had the potential to benefit the customer if implemented.

However, we acknowledge that due to lack of customer support and demands for other priorities, it is the right decision to consider this scheme as part of the RIIO-T2 price review instead.

We thank the industry and Ofgem for their engagement and time considering this proposal.

Contact

If you would like to discuss anything further, please do not hesitate to contact us.

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