NGT Potential Sale of a Gas Distribution Network

Comments on the RIA on the Interruptions Arrangements

28 July 2004

The Association of Electricity Producers welcomes the opportunity to comment on this regulatory impact assessment. We consider that consultation on this document provides an important opportunity to comment on the issues and various options under consideration.

The Association is however disappointed that the document does not present a more balanced consideration of the issues given the extensive discussions that have taken place at Ofgem and Transco chaired meetings over the past few years. We also note that at these meetings no consensus on the need for change or the type of change has emerged. In addition Ofgem has failed to address how the proposed reforms are consistent with EU legislation, despite assuring the Association and the CIWG that this will be addressed in this RIA.

We therefore consider that Ofgem is being opportunistic in deciding that reform of the exit capacity arrangements is a necessary part of a DN sale and may not be giving due regard to its statutory duties to protect the interests of customers. We do not consider that a case has yet been made for wide ranging reform to the exit capacity / interruption arrangements and suggest that resources should be focussed on the minimum change necessary for a sale to proceed, otherwise the timescale of any sale may need to be extended or there would be a risk of sub optimal solutions being developed to fit the timescale. We would expect a minimum change approach to focus on the interactions and commercial relationship at the NTS / DN interface rather than the arrangements for individual customers.

It also seems that the original reasons for reform to the exit arrangements have been lost or amended, and change is now been driven by Ofgem rather than the industry. Ofgem originally considered that there was a cross subsidy between firm and interruptible customers and between interruptible customers; it also felt that investment signals should be informed by market signals. In contrast, the main concern expressed by customers was that the current 45-day contracts were inflexible and that they would like to have other contract durations available. These issues were considered in a note sent to Ofgem and the ERAG group on 12 May 2003 (attached as Appendix 1) and will not be considered in detail here.

In this context we reinforce the points that Ofgem has yet to demonstrate:

i) that any cross subsidies exist
ii) their magnitude
iii) that markets can provide signals for investment.

We do not consider that the arrangements for entry capacity are providing meaningful signals for investment. The Association sent a note attached (as Appendix 2) to Ofgem on 10 November 2003, which explored the issues surrounding any possible cross subsidy between firm and interruptible customers and between interruptible customers. It concluded that where Transco was required to set its charges in a manner that reflected the costs it had incurred then there were no cross subsidies.

The Association has extensively reviewed this document and provides detailed comments in the body of this note. We provide a summary of our views below;

- The case for reform is yet to be made
- Ofgem is yet to provide evidence of discrimination, inefficient investment and cross subsidy

- Extensive reform of the exit capacity and interruption arrangements as part of a DN sale is both unnecessary and inappropriate
- Attention should be given to the minimum change necessary for a DN sale to proceed
- Ofgem has a different understanding of key principles such as cost reflectivity and non-discrimination than we do
- If reform is necessary Options 2A* and 2A with cost reflective prices should be considered further
- Options 2B, 2C and 3 should be disregarded as overly complex and disproportionate
- Ofgem should explain compliance with EU legislation more thoroughly
- Significant issues are still to be addressed and considered in more detail

Key issues

Ofgem has identified a number of key issues to be considered when assessing the options for the interruptions arrangements. We note that these issues seem to have evolved from the issues of concern that originally prompted Ofgem to consider that reform was necessary. We also note the omission of increased customer choice. This has been a specific feature of the objectives at CIWG meetings, although we assume this is covered by the heading "impact on customers". In addition there is an absence of any reference to cost reflective charging despite Transco having an explicit licence condition that relates to this.

No undue discrimination
The Association considers that this is an important aspect of the arrangements, since discrimination may lead to distortions in the market and inefficient outcomes. We consider that shippers should face equivalent contractual terms and conditions for the same service. Ofgem (4.6 & 4.7) extends this approach to consider the costs incurred by the shipper in providing the service as an argument for Transco paying different prices for the same service. We do not agree with this. Transco is the party subject to price controls and regulation; shipper costs are not relevant in this regard.

We also consider Ofgem's approach to be out of line with Article 4.1 of the EU Draft Regulation on conditions for access to the gas transmission networks. (See extract in Appendix 3)

Freedom to contract on market based terms
The Association considers that ideally customers / shippers should have a greater choice in the products available to them and that in principle network operators should not be required to accept more interruption than they actually require. A key issue for reform has always been trying to strike a balance between increased customer choice and network operator determined interruption, two objectives that are pulling in opposite directions. This has not been resolved in workgroup discussions. We do not however accept that 'market based' terms are the most appropriate way of achieving this and consider that "freedom to contract on market based terms" is actually an Ofgem desired outcome rather than an issue in its own right.

We consider that Transco as the regulated entity should establish cost reflective tariffs for interruption that are non-discriminatory and take into account the costs of avoided network investment as per the Gas Directive 2003/55/EC recital 16 (see Appendix 3).

Efficient investment signals
The Association considers that network operators receive clear investment signals from customers / shippers by sites opting for firm transportation. A key determinant of this will be cost reflective firm charges, a benchmark against which customers will decide to opt for firm or interruptible transportation. The network operator will then invest in a manner consistent with its licence obligations.

We accept that there might be a marginal inefficiency where sites that are firm subsequently opt for interruptible transportation, in the knowledge that they are unlikely to be interrupted. However we consider that in the medium term the network operator will not need to invest to meet other firm load growth in that area, and ultimately the inefficiency will be eroded. In any case it is not clear how significant this issue is, since Transco has reported that the number

of firm sites switching to interruptible transportation has fallen steadily in recent years with only six sites making this change in 2003 (refer to information provided to exit workstream on 27 January 2004). We do not consider wide ranging reform to the exit capacity and interruption arrangements is a proportionate response to address this minor issue.

However we do consider that there are issues surrounding new connections or existing sites wishing to go firm or increase their capacity and that customers should have more certainty that the capacity will be available when required. It is not clear that market signals are the best way of achieving this and similar results may be achieved by reviewing connection issues such as the economic test such that they work more in favour of customers. Ofgem's determination in respect of the Langage project is helpful in this regard.

Ofgem considers that customers should receive signals regarding the costs of network capacity such that this should inform their siting decisions. NTS exit capacity charges already vary with location so customers that connect directly to the NTS, including most large gas fired generators, already receive such signals. Customers within the distribution networks also receive these signals. It is not clear if Ofgem considers that charges within the distribution networks should also vary with location, as this has not been discussed at the workgroups. Whenever this has been considered previously it has been rejected on the basis that the charging arrangements would become very complicated.

Efficient operating decisions
Ofgem considers that economic and efficient system operation can be achieved by ensuring that the system operator contracts for interruption on terms that reflect the underlying costs of interruption incurred by the sites providing the service. We consider this would not be compliant with the EU Gas Directive or the draft regulation (see Appendix 3) which seems to suggest that charges for demand side services should be based on the long term marginal avoided network costs and that the same services should be provided on equivalent contractual terms and conditions. We take this to mean that adjacent sites of similar size providing the same duration interruption service to a network operator should pay or receive the same charges or discounts which should reflect the avoided network investment costs. We consider that if these sites were to pay or receive different charges or discounts then this would be discriminatory.

Low implementation and administrative costs
We agree that the implementation and ongoing costs will be a key issue. Any option that carries with it higher costs must be offset by enhanced benefits, which have a high probability of being achieved.

Security of supply
There are two elements to ensuring security of supply; firstly the appropriate infrastructure and secondly adequate gas supplies or demand side measures. The Association considers that network operators are best placed to determine the appropriate level of investment in their networks and we consider the licence obligations are a key part of this. We do not consider that shippers have sufficient knowledge of their portfolios in the timescales required to inform efficient investment decisions and consider any arrangements that rely on shippers signalling capacity requirements could result in a reduced level of security of supply. In this respect we note that the long-term auctions of entry capacity have yet to provide any meaningful signals for additional investment, although clearly investment is required to meet growing demand.

Ofgem considers a number of issues associated with interruption for supply / demand reasons, but does not explore them in any detail. It seems to consider this a separate issue. Whilst we agree with this to some extent, we consider there should be further exploration of the issues that arise from removing the ability of network operators to interrupt for supply / demand reasons as it was expected that this would be considered as part of the review of the exit regime.

Ofgem also considers some issues in relation to the interaction of the gas and electricity markets. Whilst we accept that Ofgem should consider the efficient interaction of the markets, we would suggest that it should also respect the commercial decisions made by generators in choosing firm or interruptible transportation arrangements and note that many interruptible sites have back up fuel capabilities. Ofgem also considers that the inability of shippers to trade interruptible rights creates security of supply risk, if a gas fired generator was unable to trade its interruption rights with another site. We note this security of supply risk is to the electricity market and not the gas market as there would be no net impact on the gas network if the interruption rights could be traded. Most interruptible sites have back up fuel capability and so could continue generating if the commercial conditions were appropriate. In any case there are very few sites large enough to trade capacity with CCGTs. Finally this seems inconsistent with the assumptions for the cost benefit analysis which suggests gas fired generators would place the lowest value on their capacity compared to other interruptible customers.

Impact on customers

The Association considers that the interests of present and future customers should be protected. It is therefore useful to reflect that customers want reliable gas supplies at reasonable cost, with transportation charges that are stable and predictable in advance.

Customers have indicated that they would like to have more options available to them for the way in which they contract for transportation services. At the time customers expressed this view, they considered the choice over the service chosen would be theirs, just as they can currently choose to be firm or interruptible. The options presented by Ofgem in this RIA might therefore be considered to be eroding the choice that customers have, in that the choice will no longer be entirely theirs. As stated above trying to strike a balance between customers being given a free choice and the network operators determining the level of interruption they require has been extensively discussed at the workgroups, but with no clear agreed direction.

Changing the way in which customers contract for transportation services will have an impact on them, the magnitude of which will depend on the extent of any change. Ofgem must be confident that customers in general will benefit from any reforms, such that the benefits outweigh the costs associated with any new arrangements. Any arrangements that result in ‘winners’ and ‘losers’ potentially create a different set of distortions to those that Ofgem currently believes exist. Furthermore Ofgem seems to be assuming that as a result of its reforms interruption will in aggregate cost less than it does currently, we do not consider this is likely to be the case.

Effect on competition

Ofgem considers that the creation of liquid and transparent markets for network interruption could assist a network owner in efficiently managing local network constraints. The Association considers that the creation of such a market is purely theoretical in nature. Given the highly locational nature of network or constraint interruption there would need to be many markets. Transco gave a presentation to the CIWG workgroup that explained just how

localised interruption within the distribution networks is, and that substitution may be limited to just a few streets. As a result therefore there may need to be hundreds or thousands of 'markets' even if it were possible to set exchange rates between adjacent zones. It is simply beyond belief that such 'markets' would be sufficiently liquid to deliver the benefits that Ofgem expects.

We also note that Ofgem in its RIA on the offtake arrangements has previously stated that *'Cost reflective charging (for NTS exit capacity) is a key requirement on the basis of competition. Significant distortions to competition may arise where charges do not reflect true costs*'. We agree that charges that reflect network operators' costs will prevent distortions arising that could be detrimental to competition. We also consider that cost reflectivity is an important principle for demonstrating compliance with the EU Gas Directive and the proposed Regulation on access to gas networks. We do not understand how markets are supposed to establish charges that reflect network operators costs.

In addition to the key issues identified above, the Association is disappointed that Ofgem has not responded to concerns raised by the Association on a number of occasions with respect to the proposed EU Gas Regulation on access to gas networks and the EU Gas Directive. At CIWG meetings Ofgem undertook to comment more fully on these issues in this RIA but has not done this, other than to say it is not appropriate to comment as the Regulation is still being drafted and that the intent of the Regulation is consistent with the intent of the options for interruption.

The DTI has recently advised the Association that the Regulation is not expected to change significantly before it is finally agreed. We therefore would have expected more considered comments from Ofgem as to how its proposals are consistent with the Regulation and Directive, the latter already being in force.

Options

Release of network capacity
Ofgem suggests that new arrangements need to be put in place for the allocation of capacity in the short term, when Transco is unable to invest to meet increased signals of demand. This would only appear to be an issue for new connections, sites wishing to switch from interruptible to firm or firm sites wishing to increase their offtake capacity. As these are relatively few in number, it would seem wholly inappropriate to change the arrangements for all customers. However we appreciate that Transco is required to meet all reasonable demands for gas and consider that the Langage determination is helpful in this respect.

The Association considers that an unconstrained capacity allocation at cost reflective regulated charges is consistent with the principles of non-discrimination, cost reflectivity, transparency and the requirement to publish tariffs in advance as established by Article 18.1 of the EU Gas Directive and Article 3.1 of the proposed Gas Regulation. We do not however agree that an unconstrained capacity allocation is the same as universal firm, but we do consider that the network operator should also provide interruptible capacity in a manner consistent with the proposed EU Gas Regulation Article 4.2.

In our view a constrained allocation of capacity adds unnecessary complexity and is unlikely to result in cost reflective charges, which could in turn have a detrimental impact on competition in gas supply. This has aptly been illustrated at entry.

We do not consider that it would be appropriate for there to be different arrangements for the same type of load on the NTS and DNs as this could be considered discriminatory and result in market distortions.

Interruptions Arrangements
Ofgem has asked for views on whether Transco as NTS SO should be precluded from contracting with shippers and customers at individual DN sites for the purposes of managing constraints on the NTS or whether the NTS must contract with the DNs for these purposes. To some extent this will be informed by the decision on the appropriate way forward for the offtake arrangements. In the absence of this it will be necessary to consider whether the NTS would have enough interruption for managing NTS constraints if it were unable to contract with DN sites for interruption for managing NTS constraints. This assumes that demand reduction for supply / demand reasons is no longer addressed by interruption. Limiting the NTS to contacting with NTS connected sites, would be a simple solution but might not be the most efficient. Allowing the NTS to contract with DN offtakes or DN connected sites would introduce a degree of complexity that may be unwarranted and would make monitoring the actual response to interruption more difficult. Additionally, allowing the NTS to contract directly with DN connected sites could cause problems for DN owners in managing their own network.

Option 1 – Status Quo
We consider this option provides for regulated third party firm and interruptible access services on non-discriminatory cost reflective tariffs that are published in advance. We therefore consider this is compliant with EU legislation.

Ofgem considers that the current arrangements are unduly discriminatory as they are based on network operators costs rather than customers costs or value. We do not accept this and consider that transportation tariffs should reflect network operators' costs rather than customers' costs. We also do not accept the view that the arrangements are discriminatory in that sites face different levels of interruption. We consider that interruptible capacity is a feature of an efficient network, in that it is essentially 'spare' capacity that is not being used by firm capacity holders at a particular point in time. The frequency of interruption at a particular site will reflect the fact that investment in pipelines is 'lumpy' and that severe weather conditions can affect certain parts of the network in isolation from other parts of the network. We do not consider that the arrangements are discriminatory as Transco has the right to call interruption for 45 days at every site even if it does not do so.

Ofgem is also concerned that NSLs are placed on interruption terms that they did not signal to Transco. We consider that all interruptible sites signal to Transco that they are willing to be interrupted for up to 45 days by opting for interruptible transportation arrangements. We also note that Transco has presented information on the number of NSLs by LDZ overtime, which demonstrated that NSL status is a transient feature. Going forward any sites that are unhappy with being NSLs can apply to go firm and following the Langage determination should be more assured that the capacity would be made available.

Ofgem considers that Transco may be over contracting for interruption particularly during warmer years, this seems to suggest that the 1 in 20 obligation is misplaced or that Transco should forecast winter severity in timescales consistent with investment leadtimes, the latter approach is clearly bizarre.

With respect to investment signals to network operators, we consider that network operators are best placed to plan the investment required on their systems consistent with their 1 in 20 licence obligations. There is no evidence that the arrangements at entry are providing signals for incremental investment and it is difficult to see why shippers should be more able and willing to forecast and commit to exit capacity than they are entry capacity, particularly given the dynamic nature of their portfolios.

We consider that customers already receive locational signals as to the value of capacity through the variations in NTS exit capacity charges.

In the discussion of efficient system operation decisions, Ofgem seems to confuse customer costs and value, when it is the cost to the network operator that will determine whether or not it is making efficient decisions. Ofgem is also concerned that firm sites are prevented from offering interruption, as they may not wish to commit to a 45-day product. This RIA only considers interruption for network constraint reasons and hence by definition firm sites are not constrained.

In our view the risks to security of supply are less significant under this option than any of the other options, since customers give a clear indication of their capacity requirements by opting for firm transportation. We consider relying on shippers to signal their future capacity requirements for an uncertain portfolio creates additional risks to security of supply. As discussed above the idea of liquid markets for interruption is purely theoretical.

Ofgem considers that the interruption arrangements have a detrimental impact on competition. We do not see how this is the case as the majority of large customers pay transportation charges on a pass through basis. Ofgem also considers that as a result of the current interruption arrangements firm customers are potentially being charged on a non-cost reflective basis but does not explain how this arises. It would be useful to understand this more fully.

The Association agrees that the implementation and administrative costs of this option would be low and that there would be minimal impact on customers, as they would not need to develop an understanding of new arrangements.

Option 2 – Unconstrained allocation of the firm capacity product
Ofgem states that Options 2A, 2B and 2C require an unconstrained or universal firm approach to capacity allocation. It does not comment on the capacity allocation associated with option 2A*. This option was developed by industry participants and presented to CIWG in March. It does not require universal firm capacity allocation, but does seek to strike a balance between either the customer or the network operator being able to unilaterally determine interruption terms. The capacity allocation is more in line with current arrangements, with existing interruptible and potentially firm customers indicating their preferred duration of interruption against a predefined matrix of cost reflective discounts from firm charges for various durations.

The Association notes that there is little detail as to how the unconstrained approach to capacity allocation would work, and considers that the duration of contracts and any default arrangements that would require existing interruptible sites to offer terms for interruption in the future are key features that would significantly influence any potential benefits that might arise under these options. In particular if only short duration contracts were available or sought by shippers and there were no default terms then, network operators would not receive any investment signals in timescales

within which they could respond to them. As a result they could be distressed buyers of interruption rights and could face significant costs, which would ultimately be passed onto customers.

The Association also considers that approaches based on universal firm capacity allocation have still not addressed the issues arising at the NTS / DN interface that caused the reform of the exit arrangements to be rescoped in May 2003. In particular the implications of sites being firm in so far as the NTS is concerned but interruptible within the DN. We believe that this issue must be considered in more detail.

In addition we note that when Ofgem consulted on the removal of the obligation on Transco to introduce universal NTS exit capacity arrangements from its licence earlier this year, all respondents supported the removal of the obligation.

The Association agrees that an unconstrained approach performs better than the current arrangements in terms of ensuring no undue discrimination between existing and new customers, but has concerns that such arrangements could act as a disincentive on developers to flag their intentions to the network operator at an early stage and that the costs that could arise as a result of the network operator being a distressed buyer of interruption could be significant. We note that no evidence of the magnitude of this problem has been presented and that for large sites the development lead times are similar to the network operators' leadtimes for investment and that the commercial issues can be addressed by both parties agreeing to an ARCA.

Ofgem notes that an unconstrained allocation reduces to some extent the risk of a network owner investing in assets that are subsequently not required, but that this would only occur if shippers entered into long-term capacity or interruption contracts. Ofgem also notes that shippers are not particularly incentivised to make long term bookings and that most bookings of capacity would continue on the same time horizons as now. We agree with this and therefore consider the benefits associated with efficient investment signals are overstated.

Option 2A and 2A– Pure matrix*

The document (5.2) states that *the form of the matrix would be determined via the network operator's transportation charging methodology or its procurement guidelines.* We take this to mean that where the matrix is developed in accordance with the charging methodology, the options will be reflective of the Network Operator's costs in that they will represent the costs of avoided network investment. However at a recent CIWG meeting Ofgem commented that the matrix did not need to reflect the Network Operator's costs and was an attempt to represent customers' value of interruption. This is confusing and increases the risk of inefficient investment. Customer value is not stable and varies over time. It would therefore be inappropriate to make network investment decisions on this basis, as it is a fundamentally flawed concept. The original concept of a matrix was that it was a simple administered, and therefore regulated cost reflective option.

We consider that cost reflective charges and stability are an important element for network investment and in the promotion of competition in gas supply and non-discrimination between customers. We therefore expect any matrix of charges or discounts published by a network operator to be reflective of the costs incurred or costs avoided as per the EU Gas Directive. Option 2A* sought to achieve this, by providing discounts against firm charges for various durations of interruption contract.

It is not easy to comprehend how a matrix with multiple options can be cost reflective unless all the options are equivalent in financial terms e.g. discount from firm is equivalent to option fee plus exercise fee if maximum duration called.

To the extent that the matrix under option 2A is cost reflective we would expect both options to have a similar benefits, but option 2A* would have lower initial and ongoing costs due to it not requiring new arrangements for the allocation of capacity.

In terms of no undue discrimination both options are similar if the matrix in option 2A is cost reflective as sites will receive discounts or pay charges that are equivalent for similar services. If the rows within the matrix in option 2A were not cost reflective nor equivalent in financial terms then 2A may give rise to more discrimination than 2A* since customers could receive discounts or pay charges that are different for the same service e.g. a 10 day interruption service. We do not agree that the costs incurred by the customer are relevant in determining non-discrimination; only the network operator's costs are relevant to network investment.

We agree that both options will provide some long-term investment signals, but these will be limited if shippers do not wish to enter into long-term capacity or interruption contracts. The design of the matrix could influence these signals. A key difference between the two options is also relevant here; in option 2A the network operator can only accept the 'cells' selected by the shipper /customer whilst in option 2A* the network operator can accept a duration less than that indicated by the shipper / customer. This means that under option 2A the network operator may have to accept a 30 day contract when it actually only needs 10 days, whereas under option 2A* if the customer had indicated that it would prefer a maximum of a 30 day contract then the network operator can chose to accept this for 10 days. The latter approach might be considered a more efficient outcome, and as the shipper / customer signals it maximum acceptable duration then it provides a clear signal to the network operator.

We accept that option 2A might lead to slightly more efficient system operation decisions but only if the options selected include an exercise fee and only then if that fee is cost reflective. We do not see how it is possible to set cost reflective exercise fees when the interruption relates to capacity rather than commodity.

We consider that both options potentially increase customer choice, through there being more than one interruption contract available, but as the network operator has the final say over the transportation terms the customer should be on, then some customers could argue that this amounts to less choice than exists currently. This applies equally to any option that gives the network owner the final say over the transportation terms a customer should be on.

Option 2B – Tenders for interruption

This approach allows the shipper / customer to determine the number of days interruption it offers along with the option price and / or exercise fee. As this approach focuses on customers 'value' of interruption we do not see how this provides for charges that are reflective of the avoided network investment costs. Nor how this would give consistent and efficient long-term investment signals as customer value would vary over time and by location. Nor do we understand how these arrangements will ensure no undue discrimination as the network operator may end up paying differing amounts for the same service. E.g. adjacent sites could both offer 20 day contracts at different prices, and since the operator required 30 days interruption in that area it would have to accept both. This would also potentially be an inefficient

outcome, as the operator would have purchased 10 days interruption that it does not need.

It is our view that this option is not compliant with EU legislation in respect of cost reflectivity and non-discrimination.

We also consider it likely that shippers / customers in tendering for DN interruption will seek to recover firm NTS charges, hence increasing the cost of interruption within the DN. This may then be interpreted as a signal to invest, when actually it was cost recovery such that any subsequent investment by the DN would be inefficient and unnecessary.

Option 2C – Tenders plus matrix
It is suggested that in order to avoid the co-existence of tender and matrix approaches and the potential distortions this could create, that the tenders are used to allocate long term interruptible rights and the matrix to allocate one year interruptible rights. This seems to be a complex hybrid solution that would incur costs associated with both options but without there being additional benefits. Our comments above therefore also apply to this option with the additional concern that shippers would be unlikely to commit to long-term arrangements.

Option 3 – Constrained allocation of the firm capacity product
This option appears to be replicating the arrangements at entry, which were not widely supported at the time and appear not to have achieved what they set out to do. In addition to the complexity involved the consequences have been unpredictable and have led to fluctuating transportation charges, with the associated distributional effects. This creates uncertainty and risk for all participants.

The Association does not understand how this approach is consistent with any of the options described in the RIA on the offtake arrangements whereby the NTS and DN was required to meet all requests for capacity whether these were made by DN owners or shippers.

We also do not understand the role of interruption by network operators where only firm capacity consistent with the physical capability of the network is sold. Clearly in such a situation there should be few, if any, constraints. Ofgem has recently confirmed that interruption would only be required to mange seasonal restrictions and maintenance.

The Association considers that the extent of change required by this option is disproportionate to the problems Ofgem perceive to exist with the current exit capacity and interruption arrangements. We are concerned that non-cost reflective capacity costs and uncertainty in being able to secure capacity to supply customers could have a detrimental impact on competition and the costs passed on to customers. We also consider that auctions of exit capacity rights would not be compliant with Article 18.1 of the Gas Directive which requires third party access on pre- published tariffs, nor Articles 3.1 and 4.1 of the proposed Gas Regulation which relate to cost reflectivity and non-discrimination. Article 4.2 of the Regulation is also relevant in that it requires transmission system operators to provide both firm and interruptible third party access and we do not consider allocation of firm only rights achieves this. Finally we consider the introduction of auctions would not comply with Article 3.2 of the Regulation that requires transmission system operators to actively

pursue convergence of tariff structures such that market liquidity is not restricted nor trade across borders distorted; this is because we consider it highly unlikely that other Member States will introduce auctions for network access rights.

Transitional Arrangements
The Association considers that transitional arrangements are an important feature of any reform to ensure that customers' interests are protected. These reforms may result in certain sites no longer being designated as interruptible or receiving less compensation for being interruptible than previously. Such sites may therefore face a significant and immediate increase in transportation costs that they had not planned for and in some cases may change the economics of the project. We therefore consider that customers who find themselves in these circumstances should be protected from the full financial impact of the changes from day one for a period of time. In the past where changes in the charging methodology have resulted in large step changes to charges the charges have been phased in, so we feel there is a precedent for this approach.

We do not consider it is appropriate for transitional arrangements to be subject to a cost benefit analysis, although it is reasonable to estimate the cost to the industry.

Cost benefit analysis assumptions and methodologies
The Association considers that undertaking cost benefit analysis is challenging and accepts that assumptions have to be made. However it is essential that when the results of the analysis could influence policy decisions that such assumptions are as rigorous as possible. We consider that Ofgem should also explore the risks and unintended consequences of the options along with the probability of the benefits accruing.

We consider there are a number of weaknesses in the analysis:

Short run inefficiency
- The analysis excludes NSLs as a category of customer that Ofgem considers may be unduly discriminated against in that it faces a higher probability of interruption than other customers. NSLs account for 26% of the interruptible load by SOQ[1] within the DNs; they should therefore be included in the analysis.
- This document only considers constraint interruption which if not site specific is locational in nature. It assumes customers who value capacity least will be interrupted first with no consideration at all given to the location of these customers. The difference in cost between the equitable and 'least cost' solution is therefore overstated.
- The assumptions on customer cost of interruption do not appear to include any capital costs or consequential costs arising for example, from imbalance in the electricity market and may therefore be understated.
- The relevance of customer costs is also not clear, as any benefits that might arise would accrue to individual customers rather than the market or industry as a whole.
- In Table A1.2 the probabilities assigned to the occurrence of winter conditions may reflect past experience over a long timescale but it is not clear if this represents forecasts going forward in a warmer climate. The table suggests that winters more severe than typical should occur 20% of the time, i.e. 1 in 5 years. A severe winter has not been experienced since the start of the Network Code in 1996.

[1] Transco data provided to workstream on 27 January 2004

- This analysis is all based on customer cost information and assumes that customers will offer interruption at cost, whereas the rest of the paper seeks the 'value' of interruption via market signals. The analysis is therefore inconsistent with the proposals. The difference between cost and value may completely undermine any possible benefits that could emerge from a cost based approach.
- The proportion of maximum benefit assigned to each option as listed in table A1.5 appears to be highly subjective
- Differences between the least cost and equitable approaches are small and may not be statistically significant. There only appears to be any difference at all in severe winters. Given the comments above these may be weighted too much and not reflect weather conditions in the future.
- The multi-step nature of this methodology that requires a large number of assumptions could potentially compound small variations in inputs and magnify the uncertainty in the outcome, sensitivity analysis should be undertaken to explore this.

Long run inefficiencies

- The assumptions behind what interruption Transco will require in a 1 in 20 winter are not presented. It is not clear whether this includes supply / demand interruption as well as constraint interruption. The document generally ignores interruption for supply /demand reasons but does not address how it expects this to be removed from the Network Code. It may therefore be inappropriate to say that Transco has over-contracted for interruption
- What is a 1in 20 winter? Transco's licence refers to 1in 20 peak day, severe winters are usually 1 in 50 rather than 1 in 20.
- Ofgem seems to have missed the point that interruption arrangements are long term insurance against severe winter conditions, hence if in a typical winter Transco was to utilise all the interruption it had contracted for, then there would be inadequate interruption for more severe conditions.
- This analysis assumes that market signals and flexible arrangements will lead to less investment. For there to be less investment these arrangements would need to be in place beyond investment lead times which are generally quoted as three years. Experience at entry demonstrates that shippers are unwilling to commit to capacity purchases in these timescales, it is therefore not clear as to why their behaviour should be any different at exit. Shippers may be less willing to commit to long term capacity purchases at exit due to customers being able to switch supplier at relatively short notice.
- Ofgem provides no explanation as to why a saving of 3% of capex might be achieved or how this will vary with each option, Table A1.7. We consider this to be highly subjective.

Costs of implementation and administration

- These costs have been overstated for Option 2A* since it does not require an unconstrained allocation of capacity. We would expect both one off and annual costs to be lower than option 2A

We also note that fundamental reform creates substantial regulatory risk, that could affect investor's perception of the gas market. We consider this should be included as a cost in this RIA.

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Appendix 1: Note sent to Ofgem on 12 May 2003

Alternative Proposals for Reform of the Exit Capacity Regime

On Wednesday 23 April a group of industry representatives met to consider reform of the exit capacity regime. The group included representatives from all parts of the industry that would be affected by reform to the exit regime, including; shippers, major industrial users and power generators.

The industry is united in its opposition to the forced introduction of the universal firm registration of NTS exit capacity as it does not accept that a case has been made for such change and is very concerned about the reduction in choice for customers that would result. The group would however support incremental change to the interruptible transportation regime and believes that a win/win situation is possible where customers have more choice over their transportation terms and hence the way they manage their business and Transco has more flexibility available to it to mange the transportation system.

This note provides a summary of the discussions and a list of proposals for consideration.

The group agreed that there were three main issues that had prompted the exit arrangements to be reviewed (by Ofgem) and that any solutions must address the issues.

The issues are considered in turn below:

1. Alleged cross-subsidy between firm and interruptible sites
Interruption that is contracted by Transco but not called upon could represent a cross subsidy between firm and interruptible sites. In addition a cross subsidy could exist between interruptible sites that were interrupted more than others.

Proposal:
- Ofgem should demonstrate the existence and quantify the size of the cross subsidy that occurs under current exit arrangements before proposing solutions to the perceived problem.
- Ofgem should understand the difference between peak and non-peak demand and how this led to interruption being established and the value of interruption in terms of avoided additional capacity investment.

In addition, many of the problems associated with interruption occur within the LDZ. Addressing any cross subsidies at the NTS level would not solve the problem. Many industry players (including customers) do not consider the issue of cross subsidy to be significant and some hold the alternative view that interruptible customers are subsidising firm customers through the transportation charges they pay, yet no investment has been made for them. Ofgem, however, considers the issue to be more significant.

Points to consider:
- Most problems at exit occur within LDZs rather than the NTS.
- It is not possible to solve LDZ exit issues by reforming NTS exit arrangements.

2. Lack of market signals for capacity investment

At present Transco makes investment decisions to comply with its licence requirements with respect to the provision of capacity to meet demand on a peak day. Ofgem would like to see Transco receiving market signals for the value of interruption so that it can make efficient trade offs between pipeline investment, use of storage and interruption contracts. Many industry players are sceptical as to whether Transco would ever receive adequate signals. This is because the market would not be liquid enough and wouldn't look far enough out.
Given Transco's licence condition any signals would appear only to relate to new connections or interruptible sites wishing to go firm. The group felt that these issues should be tackled directly. Extending the ARCA arrangements and increasing the transparency of the 'economic test' would help. Freeloading (where interruptible customers are exempt from firm charges but never get interrupted) is often suggested as an example of poor market signals. New customers can request firm capacity then move down to interruptible contracts knowing that Transco had invested in new capacity so that interruption was unlikely to occur. Such free loading is, however, not a significant problem and could easily be resolved by small changes to Transco's pricing methodology or Network Code or connection conditions.

Points to consider:

- There are real issues for sites wishing to go firm and new connections
- Ofgem sees free loading as a much larger problem than it actually is.

Proposal:

- Ofgem should demonstrate that free loading is a problem contributing to the poor investment signals before proposing solutions.
- Transco's economic test should be made more transparent with a clear appeals process
- ARCAs should be reviewed, with a view to making them more widely applicable to sites wishing to go firm

3. Insufficient Customer Choice

Customers want more choice and flexibility in the range of interruption arrangements available to them or the services that they can provide to Transco. Some customers are happy with the current '15 day' arrangements. Other customers are able to provide more flexibility and Transco should be able to reflect this through various interruption options or through contracts negotiated directly with customers or shippers. Ofgem's 1998 consultation acknowledged the need for more customer choice but nothing concrete has been proposed to increase customer choice since then.

Points to consider:

- Universal Firm Exit Capacity does not increase customer choice or the services available to Transco.
- Transco published a pricing discussion paper (PD15) that proposed an option and exercise product
- The proposals were put forward prior to the Universal Firm Exit Capacity proposals. Many customer groups did not support the proposal at the time, but may now see this as preferable to Universal Firm Exit Capacity, primarily because they can elect to participate.
- Customers' demand for interruption depends on a number of factors. These different factors should be reflected in the range of options available for customers.
- The exit regime could and should be improved by incremental rather than large scale and complex changes.
- Transco should set out its requirements for the exit regime. It should define a number of different requirements that might be served by a range of different options.

- Customers should have a choice not an obligation in the level of interruption they receive.

Proposal: A '*menu' of standard contract options*

- Transco in conjunction with shippers and customers should develop a menu of standard contracts for interruption.
- The existing terms should be one of the options.
- The contracts should cover a range of interruption characteristics such as number of days, length of interruption and notice periods, as well as prices/discounts.
- Each customer would have the option to select one or more of the contracts from the menu.
- Some customers might be able to offer additional levels of flexibility to Transco
- Transco should be able to negotiate terms for this directly with customers.
- The charging structure may then reflect actual interruption i.e. option and usage charge.
- Customers should still be able to agree interruption terms with their shipper as now, they should not be required to contract with Transco directly for transportation interruption.
- Customers should not have levels of interruption imposed on them.
- The standard menu of contract terms would be flexible and address Transco's, shippers' and customers' needs.
- Customers should be able to maintain their current arrangements if preferred. Additional complexity of interruption arrangements should not be imposed on sites that do not feel they would benefit from different arrangements.
- Customers should be able to interchange between being firm and interruptible i.e. they shouldn't be held to be either firm/interruptible forever. Transco operates a dynamic system and circumstances, particularly consumption patterns and weather will change. They may be interruptible and never have been interrupted but need to be available to Transco because of the 1 in 20 peak criteria.

Implementation Issues

- The Network Code will need to be modified. Transco would be best placed to bring forward a modification that covers all the relevant areas.
- Providing customers with choice in interruption terms and removing Transco's right to determine the interruption status of a site may require a lead time before full implementation.
- The ability to negotiate non-standard terms could initially be offered to NTS sites only or sites above a certain size and then rolled out to smaller volume customers
- Transco will need to bring forward a consultation on changes to its pricing methodology, consistent with the new range of interruption products.
- The Gas Act may need to be amended, or Transco may need an exemption in order to contract directly with customers
- Transco's licence will need to be amended to remove the reasonable endeavours obligation to implement universal firm registration
- Transco's incentives will need to be reviewed to see if any change is required
- The arrangements should be tied in with Transco's Connection policy.
- The safety case should not be affected, but this will be for Transco to judge.

Representatives of the following organisations were involved in the development of this document, either through attendance at the meeting or via comments on the initial draft.

Centrica
Chemical Industries Association
Edison Mission
ILEX
Innogy
InterGen
LE Group
MEUC
Powergen
px limited
Scottish and Southern Energy
Scottish Power
Shell Gas
Statoil
TotalFinaElf Gas and Power
AEP

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06.05.03

NGT Potential Sale of a Gas Distribution Network
Comments on the RIA on the Interruptions Arrangements

Appendix 2: Note sent to Ofgem on 10 November 2003

Developing the interruptible regime – cross subsidies?

This note explores the issues associated with understanding cross subsidies arising from the current exit capacity and interruption arrangements.

1. Cross subsidies between firm and interruptible customers

What costs do firm customers impose on the system?

- Transco has a licence obligation to invest to meet 1 in 20 peak day demand for firm customers. It is also required to make sure that its charges reflect the cost incurred.
- Therefore if all investment is related to meeting peak demand, TO capacity charges should relate to peak capacity, to levy charges in any other way would not be cost reflective.
- Any system operation costs arising from providing capacity or transporting gas to firm sites should be collected through SO charges

What costs do interruptible customers impose on the system?

- Transco has not made any investment for interruptible sites and they are not expected to be using capacity at peak
- Therefore interruptible sites should not pay TO capacity charges.
- Any system operation costs arising from transporting gas to interruptible sites should be collected through SO charges

CONCLUDE there is no cross subsidy from firm to interruptible customers

HOWEVER there might be a cross subsidy from interruptible to firm customers arising from charges not being consistent with a cost reflective capacity : commodity split.

2. Cross subsidies between interruptible customers

Cross subsidies are thought to exist between interruptible customers, since they all receive the same discount (exemption from exit charges) but provide Transco with different levels of service.

- In a mild winter Transco interrupts sites for different numbers of days, depending on system conditions, constraints etc. It is not incentivised to minimise the number of times it interrupts a site until the day count exceeds 15, when payments per interruption are triggered.
- In a severe winter Transco would need to interrupt all sites simultaneously for 15 days and interruption would be required on 60 other days. (presentation to workstream on 14/10/03)

So it would seem that Transco has currently contracted for the ‘correct’ volume of interruption at peak but for some sites has contracted for more days (45) than it actually needs.

NOTE: there may be an issue here that relates to shippers being able to designate firm sites as interruptible. The effects may be temporal or more wide ranging, depending on how often and how much SOQ this relates to. Perhaps Transco should be asked to present some data on this.

HOWEVER if a cost reflective charge / rebate per interruption could be introduced then this might address the issue of Transco having contracted for too many days!

> BUT Transco's costs that are avoided by having interruptible contracts are (virtually?) all fixed costs, ie pipes not layed. So if Transco's charges are to be cost reflective then it should pay a fixed fee for a site being interruptible irrespective of the number of days interruption it is allowed to call or actually uses.
>
> This would not incentivise Transco to minimise the number of days interruption it calls and hence may not be favoured by customers.

CONCLUDE there is no cross subsidy between interruptible customers, except to the extent that exit charges foregone are not cost reflective.

The idea of determining the 'value' (or customers costs) of interruption is spurious so long as Transco is required to charge for exit capacity in a cost reflective way.

Julie Cox
10.11.03

NGT Potential Sale of a Gas Distribution Network
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Appendix 3: Extracts from EU legislation

Directive 2003/55/EC concerning common rules for the internal market in natural gas

Recital 16 ….In carrying out these tasks (agreeing tariffs or methodologies) national regulatory authorities should ensure that transmission and distribution tariffs are non-discriminatory and cost reflective, and should take account of the long term, marginal, avoided network costs from demand side management measures

Article 18.1 Member States shall ensure the implementation of a system of third party access to the transmission and distribution system, and LNG facilities based on published tariffs, applicable to all eligible customers, including supply undertakings, and applied objectively and without discrimination between system users. Member states shall ensure that these tariffs, or the methodologies underlying their calculation shall be approved prior to their entry into force by a regulatory authority referred to in Article 25(1) and that these tariffs – and the methodologies, where only methodologies are approved are published prior to their entry into force.

Draft regulation on conditions for access to the gas transmission networks (as at 16 June 2004)

Recital (6) It is necessary to specify the criteria according to which charges for access to the network are determined to ensure they fully comply with the principle of non-discrimination and the needs of a well functioning internal market and take fully into account the need for system integrity and reflect efficiently incurred costs

Recital (7) In calculating tariffs it is important to take account of costs incurred, as well as of the need to provide appropriate return on investments and incentives to construct new infrastructure. …..

Article 3.1 Tariffs or the methodologies used to calculate the tariffs applied by transmission system operators, approved by the regulatory authorities pursuant to article 25 (2) of Directive 2003/55/EC as well as tariffs published pursuant to Article 18(1) of that Directive shall be transparent, take into account the need for system integrity and its improvement and reflect actual costs incurred whilst ensuring appropriate incentives with respect to efficiency, including appropriate return on investments, and where appropriate taking account of the benchmarking of tariffs by the regulatory authorities. The tariffs or the methodologies used to calculate the tariffs shall be applied in a non-discriminatory manner.

Article 3.2 Tariffs for network access shall not restrict market liquidity or distort trade across borders of different transmission systems. In case differences in tariff structures or balancing mechanisms would hamper trade across transmission systems, and notwithstanding Article 25(2) of Directive 2003/55/EC, transmission system operators shall, in close co-operation with the relevant national authorities, actively pursue convergence of tariff structures and charging principles including in relation to balancing.

Article 4.1 Transmission system operators shall ensure they offer services on a non-discriminatory basis to all network users. In particular where a TSO offers the same service to different customers, it shall do so under equivalent contractual terms and conditions, either using harmonised transportation contracts or a network code approved by the competent authority in accordance with the procedure laid down in Article 25 of directive 2003/55/EC

Article 4.2 Transmission system operators shall provide both firm and interruptible third party access services. The price of interruptible capacity shall reflect the probability of interruption.