

Centrica Energy

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Sonia Brown Director, Transportation Office of Gas and Electricity Markets 9 Millbank London SW1P 3GE

Dear Sonia,

Re: Regulatory Impact Assessment – Interruptions Arrangements

British Gas Trading (BGT) welcomes the opportunity of responding to the Ofgem Consultation on the Regulatory Impact Assessment (RIA) of Interruption Arrangements related to Transco's proposed sale of Distribution Networks.

Your consultation document helpfully provides the background to the debate on Exit Capacity and Interruption which has taken place over the last few years. We offer comments on this background and the principles of the issues to be addressed as well as the indications contained within the RIA.

Background

Although the debate has continued for a number of years, there has not been common agreement as to the nature and extent of the problems to be addressed in this area.

Your Summary highlights the main points to be addressed in the review and we use this as a structure for this response.

Currently there is a standard interruption designation where a site is required to offer 45 days of interruption. Therefore, where the Transporter identifies on the load duration curve a need for reducing demand for any period to meet peak day requirements they must enter an arrangement for 45 days. Any "un-required" days of interruption may be used as Shipper interruption and therefore creates uncertainty for the customer regarding the nature of interruption, whether for commercial or transportation constraints. All such customers will receive the same benefit for being designated Interruptible in that they will not pay capacity charges. This is neither efficient nor effective. In addition, since the introduction of SO Incentives, the shipper of an interruptible customer will received a payment of 1/15th of these charges for any interruption in excess of 15 days. In this respect alone it does mean that sites which are more frequently interrupted do receive greater compensation

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The current arrangements for interruption exist at less than 1,500 supply points. These are customers consuming more than 5,861,420 kWh (200,000 Th) per annum, prepared to cease taking gas when due notice is given. Of the total population of interruptible customers, very few (probably less than 50) are Very Large Daily Metered Consumers (VLDMC), with annual consumption above 1,465,355,000 kWh (50,000,000 Th). With this diversity of population it can be seen that some consumers will regard energy as fundamental to their business and will welcome the ability to manage their energy costs in complex and imaginative ways. At the other end of the scale, there are customers where energy is a second or third order concern and their primary concern will be to minimise costs at minimal effort.

Within the total population is a category of Network Sensitive Loads (NSLs) which are located on critical parts of the network where interruption is required at that specific point to preserve security of supply at times of high demand. The number of NSLs has increased of late as firm load in the networks has increased. There is a potential for these NSLs to wield the power of this position in a market process, if this were unchecked.

To address each of these issues the solution required must offer simple and effective mechanisms for the Transporter to enter into arrangements for only the required level of interruption with any of those customers having expressed a willingness and ability to provide such a service, but without any party being able to exert excessive influence from the nature of their position on the network.

The Regulatory Impact Assessment (RIA)

Although the RIA specifically states that there is no preference for a particular method of interruption arrangements, Ofgem has clearly indicated that Option 3 does most closely meet their interpretation of the objectives. We believe that the total costs to the industry as a whole of this option are understated, due to the complexity of the solution, which would be required.

It is also stated that the Regulator has formed the view that reform is necessary. Whilst we agree that the current regime does not meet with the objectives stated and that some reform is required, we do question the necessity to achieve this reform within the context of the Sale of Distribution Networks. Whilst the Offtake arrangements at the NTS to DN connection does require the provision of a clearly defined operational procedure (due to the ownership of the assets either side of that connection), we are strongly of the opinion, together with the majority of Shippers, Suppliers and Customers, that the timing of the reform of interruption is not dependent upon the sale of Networks.

Specific points

Option 1 – Status Quo

We appreciate that it may be in the interests of brevity, but the description of the Status Quo is inaccurate. This is particularly important as it is applied as a basis for comparison and therefore undermines the validity of the weight attributed to the other options. The key omission is the manner in which capacity is allocated. This is allocated for all firm sites; based upon deemed usage, load profile and algorithm for Non-Daily Metered (NDM) sites or by actual consumption in a prior period in the case of Daily Metered (DM) sites. Only DM sites consuming above 5,861,420 kWh per year can elect for interruptible status. Shippers do not request capacity in the current environment.

Option 2 – Unconstrained Allocation of Firm Capacity

Option 2 contains the solution that most closely resembles the consensus reached by the majority of the industry in recent discussions culminating in Ofgem's own Exit Reform Advisory Group. This represents a development of the existing regime where capacity is offered primarily as a firm unconstrained product but with an arrangement for shippers and customers to enter into arrangements for interruption. The matrix approach would cater for the majority of current interruptible supply points, requiring a simple administered approach. This could be combined with a tender type process to offer more sophisticated products for consumers able and willing to offer such a service. Either could be available to existing firm customers that wished to participate. This is represented by Option 2C. Although we recognise the potential for distortion of a market bidding process by the existence of a matrix, there are mechanisms to limit this effect. This includes the distinction of a longer term market based approach as suggested. This would also meet the requirement to provide a signal for investment.

Option 3 - Constrained Allocation of Firm Capacity

Under this option, the need for interruption rights becomes unnecessary, as it would institute a regime where gas does not flow unless capacity is held. This may at first sight seem simple and attractive. However, we believe that the complexity involved in initial acquisition of a quantity of a constrained amount and subsequent trading of capacity to adjust holdings to match gas flows on the day will require high investment in systems and highly trained staff. The consequence of managing a regime such as this would be significant exposure to overruns or similar. Of greater concern is the high potential for error and uncertainty in the holding of capacity and this does raise issues for security of supply where the physical capacity could be exceeded. These issues will also impact upon a shippers ability to balance their portfolio and the commensurate risk associated with these processes.

As stated in our response to the RIA on Offtake Arrangements, we believe that there must be consistency of arrangements for allocation of Exit Capacity. The application of a constrained product to shippers, through the arrangements for interruptions, is not consistent with the manner in which Exit Capacity would be allocated to Distribution Network Operators if this option were selected.

Transitional Arrangements

We sympathise with the view that sites which are no longer required as interruptible should be subject to some transitional arrangements to mitigate the impact of costs, but this should not unduly constrain the ability of Transporters to avoid unnecessary costs. Conversely, we would not wish to experience unnecessary costs arising from the market power of NSLs. Although in many cases there will be no available substitute aside from significant investment, consumers generally and Domestic customers specifically, will require some protection from the potential abuse of this position.

We note the differentiation between those sites with and without alternate fuels, this is required to reflect an investment on the part of the customer to provide the service compared to a pure opportunity cost.

More generally, the Transporter should be in a position of having a clear option either to enter into an agreement for interruption of to invest, in the case of the latter there needs to be a transitional provision for the period in which the necessary works can be completed

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Costs and Benefits

We agree that the calculations are driven by the assumptions made in the analysis, and it is in this respect that we believe that the interpretation is flawed. Although difficult, this analysis is critical to the selection of the regime. If the costs have been significantly understated as we believe, the additional cost will be borne by the industry and customers for many years to come. (6.2)

As stated above, we believe that the Status Quo is inaccurately represented and would require some adjustment. For this reason we believe that the use of the Status Quo as a reference point is flawed. In this respect, the simplicity of the existing regime is a positive benefit, which should not be discounted. (6.8)

If Users are required to play a greater part in forecasting their capacity requirements, this will require new skills to be developed for many players. Very few will already have staff versed in these processes and there will be significant diseconomies of scale in adopting this approach. Similarly, trading of capacity at this level does not exist at present. We have severe doubts that a liquid market would develop. (6.13)

Ofgem implies that the development of systems to support the matrix applications process is optional. This cannot be so. In addition, customers will not perceive the costs of the new regime as minimal if it does not produce the desired outcome. (6.16)

We believe your assertion that shippers benefit from reduced transportation charges to be incorrect. We are not aware of any cases where the benefit of the reduction in transportation charges from a site being designated as interruptible is not passed on the customers. (6.23)

Greater regional cost reflectivity in the charging regime will only benefit fuel poor customers if they happen to live in a cheap area – the converse is also true, cost reflective charging will increase rates to the fuel poor and other customers in the relevant regions. Neither group will have any ability to respond to the changes and therefore should be considered inequitable. (6.23)

We do not understand why Option 2B performs less well than Option 2A in terms of administrative costs and simplicity yet is judged to be less costly (Table 6.2)

There appears to be little justification for the £5m included for "long term inefficiencies" (6.36) The effect of the caps will be entirely dependent upon how they are applied (6.40)

Appendix 1

Equitability Algorithm

There remains a need for a mechanism to ensure that interruption is applied equitably among those alternatives available to the System Operator. The methodology to be designed for selection of a site to be interrupted will need to be more reflective of actual requirements but this will also need to take account of any substitutability between the options in maintaining the equitability.

Long run inefficiencies

The inflexibility of the "one size fits all" 45 day interruption contract is the major flaw in the current regime. The introduction of more varied contracts will reduce these inefficiencies by tailoring the level of interruption contracted to the requirement on that part of the network. If this can be achieved by a simple mechanism it must be regarded as a more efficient process.

Costs of Implementation and administration

We believe that the figures applied for implementation and administration in the analysis for the more complex solutions (mainly Option 3 (and some of option 2)) are seriously understated. To our

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knowledge, no Users have contributed information of their estimation of these costs under the constrained model. We believe that both the initial allocation of a constrained product and the establishment of systems to support capacity trading and transfer at the level required would be costly to put in place. This is without allowance for the risk of failure in transferring capacity on a timely basis and the resulting exposure and threat to system security.

In addition to the above points, as Option 1 does not equate to business as usual, and will involve changes to the way in which shippers operate, the costs caused by this option also need to be evaluated.

Summary

The headings provided in your Summary provide a framework for comparison of the alternatives presented in the RIA against the key issues.

- No undue discrimination the ability to enter an arrangement for interruption service should be available to all transporters, shippers and customers on an equitable basis. The fact that some firm sites may be paying higher charges than they otherwise would is undoubtedly true, however, we are not convinced that the costs of extreme solutions are justified.
- Freedom to contract on market based terms although a sound principle, many customers have clearly signalled that they would be unwilling to enter complex arrangements for interruption and this level of demand shedding may be lost unless there is a simpler alternative. The cost of the resultant network reinforcement would be borne by all consumers. These increased costs will have a greater impact upon domestic customers. As the current population of interruptible consumers is modest we believe that consideration should be given to a survey being carried out to ascertain the level of interest in complex arrangements. The results and response rates should be categorised, audited and published in aggregate prior to any decision being made. There is a real danger that if the arrangements are too complex and costly to operate, that customers may prefer to withdraw completely from interruptible arrangements. If this were to be the effect Transco will need to seek alternative interruption in order to meet the safety case (as an alternative to inefficient re-enforcement) which may only be available at an administered rate.
- Efficient investment signals whether via a market based terms or a simpler administrative based system, the provision of alternatives to reinforcement to the Transporter will provide investment signals. A purely market based signal for investment is not a sufficient substitute for central planning given the varying appetite for risk which exists and the limited nature of the market. The arrangements for acquiring capacity must be equitable for new and existing customers and their shippers. With regard to investment signals for customers, we do not believe that gas transportation price is likely to be the overriding factor when siting new plant.
- Efficient Operating Decisions effective design of both market based and administered arrangements, combined with appropriate incentives placed upon the Transporter will provide a framework for the most cost effective operational solution to be deployed. Although less interruption per se may be available in total, the key question is whether it is sufficient to meet the needs of system security.
- Low implementation and administrative costs this is inversely proportional to complexity. We believe that complex arrangements will significantly increase costs, both for implementation and operation. Greater cost and complexity will also dis-incentivise Shippers and customers to enter into arrangements for interruption
- Security of supply this is an overriding consideration, ultimately the system must meet standards set for security of supply. The goal is to achieve the efficient balance between investment in pipelines and the ability to reduce consumption.
- Impact on customers this reform has the potential to impact customers greatly. As mentioned above, some currently interruptible customers may be unwilling or unable to enter into interruption arrangements if these are too costly or complex to manage. The consequence of Page 5 of 5

this is unnecessary investment in the transportation system will be inefficient additional costs borne by consumers generally. This is particularly relevant with the principle of shallow reinforcement established following the Langage decision. This could have a detrimental effect upon those in fuel poverty.

• Effect on competition – complex arrangements combined with ability to diversify loads will favour larger Users. We believe that facilitation of effective competition between gas fired power stations can be achieved within a simpler structure than proposed in Option 3. It is transportation charges which will be impacted by this reform not gas prices

We believe that an unconstrained release of capacity with a matrix type arrangement for acquiring the appropriate levels of interruption (Option 2A) most closely meets this requirement. Where it is established that there are customers able to participate, it would be possible to develop a tender based process without appropriate controls to limit the effect of the existence of an administered price matrix, which is represented by Option 2C.

In our opinion, these relatively simple solutions would address the majority of the concerns. The cost and complexity of achieving a position apparently favoured by the Regulator (Option C) within the workgroup discussions would be out of proportion to the commensurate benefits. We believe that the RIA is seriously flawed in the under-estimation of these costs.

I hope that this information is helpful in the assessment of the benefits of the proposed reform.

Please contact me if you require any further information.

Yours sincerely,

Mike Young Commercial Manager

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