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Interruptions arrangements – Regulatory impact assessment

Dear Sonia,

RWE Innogy, and its npower branded gas supply and shipping businesses, welcomes the opportunity to comment on the above document.

In determining whether Transco should be allowed to dispose of DN assets it is right and proper that Ofgem consider how NTS exit capacity should be released and how this impacts and interacts with the current interruptions regime.

As Ofgem point out however, they have been calling for reform of the interruptions regime since the late 1990's and so, in our opinion, it is opportunistic of Ofgem to insist that reform of the interruptions regime is a necessary pre-requisite for determining whether to allow DN sales to proceed.

Despite extensive discussion at industry fora over the last 3-4 years little progress has been made in developing consensus on the need for change or the type of change that is required. This is not because shippers have deliberately frustrated the process but because Ofgem have failed to demonstrate the materiality of the cross subsidies they claim exist between firm and interruptible customers, and between interruptible customers. It is disappointing therefore that Ofgem have not taken the opportunity to expand on this further within the document.

Shippers have also expressed doubts that adopting market-based interruption solutions would generate effective investment signals, and that liquid secondary markets would develop. Whilst Ofgem have not expressed a preference for any particular method of interruption, the fact they believe that reform of the existing regime is necessary indicates that they wish to see market based solutions adopted. Again it is disappointing therefore that Ofgem have chosen to ignore some of the difficulties shippers perceive exist with market based solutions in the document, as these have been raised repeatedly at the CIWG.

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Shippers, and in particular the Association of Electricity Producers (of which we are a member), have also raised concerns that some of the options under consideration appear to be at odds with the EU Gas Directive. We do not believe Ofgem have adequately addressed these concerns in this document, and would expect them to provide a more detailed response to theses concerns in their decision document.

Our response to this document should be considered in conjunction with our response to the regulatory impact assessment (RIA) on Offtake Arrangements. However, as Ofgem has not concluded whether Transco should contract with DN shippers/customers and/or DN owners for NTS Exit Capacity, we have found it difficult to interpret how the core options, and their derivatives, would work in practice.

In our opinion network owners should be responsible for contracting for their interruption requirements principally from offtakes connected to their network. However, under certain circumstances (e.g. above an AQ threshold) shippers/customers with sites connected to a DN network should, with the approval of the relevant DN (which would not be unreasonably withheld), be entitled to offer interruption services to the NTS if they so choose.

Ofgem lay out a number of issues they regard as being key to the interruptions regime, and our comments on these are as follows.

Promoting economy and efficiency

Whilst we would not disagree with Ofgem's description of the features one might associate with an economic and efficient interruptions regime, we question whether it is possible for all these features to exist concurrently bearing in mind the practicalities of the UK gas network.

In our opinion the key features of an economic and efficient interruptions regime are that there is no undue discrimination and that it allows for efficient investment signals and operating decisions.

These features, we believe, are largely provided in the current regime through Transco's licence obligations and incentives, and we are not convinced that the regime will necessarily be improved through radical reform along strict economic principles.

Whilst we would like to see customers/shippers afforded a greater choice of interruption products, we do not think it appropriate for shippers to offer up interruption to network operators based solely on their costs, at least not for capacity interruption.

We also agree that network operators should not be required to contract for more interruption than they require, but this should be achievable by offering interruption terms based on a network operators alternative investments costs. There is no necessity in our opinion to create a two-sided market where shippers/customers offer interruption terms based on their alternative costs, as these costs are irrelevant to any investment decision.

The network operator is the monopoly party, and is the party that should be required under its licence to set charges that are cost reflective and non-discriminatory. This will allow shippers to make a clear choice between opting for firm transportation, where they cannot be interrupted, as opposed to interruptible transportation, where they could be interrupted for a specified number of days and for a specific commercial benefit. The fact that a shipper may face a higher risk of being interrupted because of their locational position on the network is a secondary issue shippers/customers would need to consider, but this does not necessitate the introduction of a two-sided market.

Ofgem argue that locational signals on the gas pipeline system should facilitate greater efficiency in siting decisions for generation plant, which should benefit electricity customers. However, even if such signals were to arise, they are likely to be insignificant when compared to other factors influencing the

siting of generation plant (e.g. transmission access costs, cooling, land availability etc).

We are also concerned that introducing market based solutions will significantly increase the complexity and implementation costs associated with exit and interruptions. Ofgem have relied on assumptions and information provided by Transco to estimate the impact any changes will have on shippers, and as stated later on we have serious concerns about this approach.

Security of supply

Ultimately it will be for the HSE to determine whether any changes to the exit and interruptions regime will ensure that a safe and secure pipeline systems is maintained.

We believe that separating interruption for capacity and energy balancing purposes, and considering them as separate products, will allow the industry to focus on security of supply issues more effectively. For the purposes of this document however, we have assumed that contracted interruption is required for both purposes.

If liquid and transparent markets for exit interruption fail to develop this could have a detrimental effect of security of supply. Based on evidence presented by Transco at the CIWG, that emphasised the highly localised nature of capacity interruption and the difficulties associated with substitution, and based on the experience at entry, we have every reason to believe this will be the case.

We agree that to the extent there is uncertainty in the probability of interruption being called, this may affect the shipper's ability to price interruption. However, the uncertainty faced by shippers over the future spark spread, the weather, plant availability and volatility will also significantly challenge their ability to accurately price interruption. It would be naive therefore to assume that shippers will necessarily offer interruption (or offer interruption at a level that is likely to be attractive to a network operator) if market based solutions were available to them.

We do not believe that introducing a market based regime for interruption will enhance security of supply in electricity as many CCGTs already have back up arrangements and can continue to generate in the event of interruption. It is also the case very few sites are large enough to trade capacity with CCGTs. Also when interruption is required (either for capacity and/or energy balancing purposes) it is usually required at relatively short notice, leaving little time for rights to be traded even if liquid markets did exist.

Impact on customers

We agree with Ofgem that customers have consistently suggested that the range of interruptible contracts offered by network operators is overly limited, and it was these concerns that prompted the initial review of the interruptions regime.

However, in that this review has now broadened significantly in scope, it is important to consider the impact that the options presented in this document will have on customers, and we detect very little appetite from customers, or from the large customer trade associations, for introducing fundamental market based reforms.

As Ofgem point out, for many customers exit capacity costs are a relatively insignificant aspect of their day to day operating costs and pale into insignificance when compared to the currently prevailing wholesale cost of gas. Arrangements that place additional administrative burdens upon them, or require them to contract in a different way (e.g. for a longer term to tie in with investment timescales), are unlikely to be welcomed therefore.

Impact on competition

The number of companies offering shipping services to suppliers, and the number of new entrant suppliers, have reduced rapidly over the years. Whilst this is no doubt due to a number of factors, we believe that the increasing complexity of shipping arrangements is undoubtedly a contributory one.

Introducing further complexity and risk to shippers/suppliers will exacerbate this trend, and be detrimental to competition in general.

The distortions that result from gas balancing interruption costs not being reflected in cash out prices, and the efficiency of interactions between gas and electricity, should be considered independently of the issue of DN sales. They do not require fundamental change of the exit regime to solve, as is demonstrated by Transco's recent modification proposal 705.

Ofgem have also asked for comments on the options presented for the future interruption regime and the transitional arrangements, and these are included below.

Option 1 - Retention of the status quo

As we do not believe it necessary or appropriate to introduce fundamental reform of the interruptions and exit regime as a pre-requisite for a decision on the sale of DN assets, Option 1 is our preferred option.

Whilst we would like to see more options available to shippers/customers to contract for interruption services, we believe that by considering interruption as separate capacity and energy balancing products and by removing the presumption that the future interruption regime should be based on the principle of "universal firm", these options can be brought about through incremental change.

Despite Ofgem stating that status quo has the "potential" of being unduly discriminatory, they have never quantified the extent, or materiality, of the actual discrimination they believe currently exists.

Ofgem also express concern that Option 1 results in NSLs being placed on interruptible terms that they have not offered to network operators. Whilst this is the case, we would assume that Ofgem's determination on Langage will encourage NSLs to re-apply for firm capacity if they are unhappy with the terms offered to them, as the precedent for shallow connections charging has now been set.

As stated in our response to the Offtake RIA, we believe that network operators are best placed to determine the investment required on their networks in accordance with their licence obligations. We do not believe therefore that requiring shippers to enter into long term firm financial commitments for exit capacity will necessarily enhance the efficiency of network investment decisions, and doing so may, in our opinion, undermine security of supply.

We also believe that Ofgem's concerns that the current regime is likely to distort retail competition, because shippers supplying pre-dominantly interruptible customers are able to provide gas on more commercially favourable terms than competitors that have larger firm portfolios, are misplaced. This is due to the fact that transportation is a pass through cost for the vast majority of large customers.

Option 2

Ofgem have presented a number of derivatives of Option 2 based on an unconstrained, or universal firm, approach to the release of firm exit capacity.

We remain of the view that a universal firm approach to firm exit capacity and interruptions is neither necessary or beneficial, and the fact that little progress has been made over the last few years in determining how it could practically be adopted emphasises the difficulties and impracticalities associated with this methodology.

However, option 2A*, which was developed by shippers in response to options tabled by Ofgem at the CIWG, was not based on the universal firm methodology. Whilst investment takes place network operators could insist that interruptible customers remained interruptible up to their current number of days but they could not require customers to increase their number of days without mutual agreement.

Of the four derivatives presented we believe that Option 2A* (and potentially 2A) could form the basis of incremental reform of the exit and interruptions regime. However, we do not believe that they necessitate a universal firm approach, or that they need to be pursued within the timescales of the sale of DN assets.

Options 2B & 2C are we believe overly complex and impractical to implement for all but the largest sites, and could result in network operators paying significantly higher costs for capacity interruption than under options 2A and 2A*. This is because we believe that customers/shippers will include large risk premiums in their interruption tenders and that shippers will seek to recover the cost of firm NTS exit capacity in their interruption tenders, thus increasing the cost of interruption to the DN.

Option 3

Option 3 adopts a constrained approach of selling a baseline level of exit capacity and incentivising network operators to release incremental firm exit capacity. As such it would appear to be an attempt to replicate the entry regime at exit.

It suggests that shippers would purchase long term tradable firm entry capacity through an auction mechanism, and that interruptible capacity would be released on an annual, monthly or daily basis. This presumably would then be allocated using the matrix, tender or matrix and tender approaches described.

Ofgem suggest that network operators would be able to meet their obligations to provide firm baseline and firm incremental capacity by either investing in the network or by choosing to buy back capacity. However, we struggle to understand how buying back capacity differs from network operators entering into interruption contracts to cover capacity constraints.

Transco have stated that the introduction of long term auctions at entry has yet to generate any meaningful investment signals, and prices in the most recent entry auctions have consistently cleared at the reserve price. We believe these experiences would be replicated at exit were auctions to be introduced, which means that exit capacity would continue to be allocated at the network operators long run marginal cost as is currently the case under Option 1.

As stated in our response to the Offtake RIA, we have concerns about a regime where shippers are required to contract for exit capacity on a long-term basis bearing in mind the unpredictability of their portfolio demands. We also believe it will be extremely difficult to establish functioning secondary markets for exit capacity and even if this could be achieved, experience at entry (where arrangements are likely to be significantly less complex than at exit) suggests these will be largely illiquid. Therefore, we are strongly opposed to Option 3 and all its derivatives and do not believe that such radical change is necessary to address the problems Ofgem perceive exist with the current exit and interruptions regimes.

Transitional arrangements

Transitional arrangements to protect customers from the financial consequences of any fundamental change to the exit regime may be appropriate, but have been one of the barriers to progress on developing a consensus for reform of the exit regime.

It is not unreasonable to expect that companies who have entered into interruptible transportation contracts on the basis that they have back up fuel capability should, for a limited period of time, be cushioned from the full financial impact arising from the loss of any interruptible discount. We would

expect this to be implemented using a glidepath approach as opposed to creating grandfather rights.

However we do not, as a rule, consider it appropriate to compensate companies for the cost of stranded back up assets, as we believe these to be largely sunk costs which have depreciated fully. There are also significant operational cost benefits resulting from not having to maintain and test this equipment to ensure its reliability (assuming this is being done in the first place, which is not always the case) and in not having to maintain oil stocks.

In exceptional circumstances it may be appropriate to deviate from this rule, and we envisage arrangements could be put in place whereby customers/shippers appealed to Ofgem in the event they felt this rule to be discriminatory towards them. Ofgem could then appoint an independent consultant (at the shipper/customers expense) to evaluate their case, and if it was found to be valid compensation could be provided over and above that received for the loss of interruption discount. Further consideration is needed however, as to how these costs should be funded.

With regard to transitional arrangements to address market power, we do not believe that price caps are necessarily appropriate. However, under Option 1 and Option 2A* (assuming this is not based on the principle of universal firm), we do not believe that shippers/customers will have opportunities to abuse their market power.

Finally, Ofgem have asked for comments on their analysis of the costs and benefits of the options presented and the assumptions that underpin this. Whilst recognising the inherent difficulties in estimating the costs and benefits arising from such changes and understanding that some judgements can only ever be qualitative, we do have the following concerns regarding this analysis.

1) Our principal concern is that the implementation and administration costs of the various options seem to have been significantly understated. Whilst we are not in a position to challenge the information provided by Transco, we do find it difficult to believe that, based on IT estimates previously quoted by Transco (e.g. > £10m for Option D in the Agency and Governance RIA), system development costs for Options 2 & 3 range only between £2-3m. Each of these options will presumably require development of a completely new system for exit capacity/interruption booking which will need to replace or amend existing functionality within the SPA process and interface seamlessly with AT Link, UK Link and billing systems.

   We are also surprised that Transco estimate the annual ongoing cost of administering these complex arrangements across all networks amounts to just £1m (or 12.5 full time employees).

   Shippers one off and on going costs have also been significantly underestimated in our opinion. Ofgem's assumption that each shipper will face development costs of £125k might be realistic for the new system development requirements, but any development requirement needed to existing systems is likely to dwarf this, and could easily be two or three times this figure. The ongoing costs are also unrealistic bearing in mind shippers are likely to have to employ extra resources in estimating their capacity requirements, attempting to trade capacity, booking capacity/interruption, notifying customers of interruption and verifying capacity invoices.

2) Ofgem's analysis of the short run inefficiencies associated with the status quo attributes different proportions of the maximum benefit arising from economic and efficient interruption to each option. This is based on Ofgem's subjective assumptions about the extent to which each of these options allows for customers/shippers to signal their cost of interruption to network operators. However, it fails to take account of the fact that interruption, particularly capacity interruption, is highly location sensitive, and so network operators may have little option but to interrupt sites regardless of whether that site is the lowest cost option.

3) Ofgem have attributed significantly lower proportions of maximum efficiency benefit and percentage improvement in capex benefit to option 2A* compared to Option 2A, but have attributed the same implementation costs to both options. The net effect of this is that this Option 2A* would appear to be worse (albeit marginally) than maintaining the status quo. The model presented by shippers to Ofgem on which Option 2A* is based did not assume universal firm, but was felt to be a way of introducing changes on a incremental basis to address some of the previously expressed concerns about the current regime. We struggle to believe therefore that it would worsen the current position, regardless of what Ofgem's modelling may suggest.

4) Ofgem's classification of winter conditions appears to assume a 1 in 20 occurrence (5% probability) of a very severe winter. However, under the network code a severe winter is defined as a 1 in 50 occurrence, and so it would seem more appropriate to attribute a 2% probability to this. We also fail to understand why the probability of a typical winter is shown as 60% in table A1.2 (as it is assumed to occur on I in 2 occasions), and why the probability of mild and severe winters are shown as 15% (and not 20% based on a 1 in 5 occurrence) in tables A1.2, A1.3 and A1.4. These probabilities play a significant part in determining the estimated benefits of each option, and taking into account the above points it would seem to us that the benefits of each option are likely to have been overstated.

5) The cost of interruption for the low, medium and high customer classes referred to in Table A1.1 would appear to be broadly in the right ball park, although these could change significantly going forward. However, in the case of power producers, it cannot be assumed that they will necessarily cease generation completely if the spark/spread supports this as doing so could cause operational difficulties. It is far more likely that power producers will attempt to profile their load, and reduce generation outside peak periods, so it is unlikely power producers will be able to deliver all of the optimal economic interruption efficiency benefits that the modelling assumes.

6) Due to the large number of assumptions that have had to be made, and that some assumptions are based on other assumptions, small variations could have a large impact on the outcome of the analysis. With this in mind, and bearing in mind the costs and benefit it has not been possible to quantitatively assess, we consider there to be a large degree of uncertainty associated with the benefits presented against each option.

Ofgem argue that they have been conservative in their analysis of the net benefits that are likely to arise from the reform of the exit and interruption regimes. In reality however, there is know way of knowing, either before or after the event, what the real financial consequences of each of these options will be. Nevertheless, based on the analysis presented, the highest net benefit of any of the options when NPV'd over an 18 year period (£22m), is less than the cost that some football clubs are currently prepared to pay to acquire the relatively short term services of a star player.

Bearing in mind the significant market disruption that could arise from these options, the lack of detail surrounding how they will work in practice, the failure to quantify the materiality of any existing inefficiencies and the lack of any formal risk assessment or sensitivity analysis, we do not believe a compelling case has been made to justify a move away from the status quo.

Should you wish to discuss our response in more detail, or require clarification of any the points we have raised, please do not hesitate to contact me.

Yours sincerely,

Stephen Rose

Economic Regulation