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

Head Office
Inveralmond House
200 Dunkeld Road
Perth
PH1 3AQ

Telephone: 01738 456400
Facsimile: 01738 456415
email:

Our Reference:
Your Reference:

Date 28 July 2004

Dear Sonia

National Grid Transco – Potential Sale of Gas Distribution Network Businesses Interruption Arrangements Regulatory Impact Assessment

Thank you for the opportunity to comment on the options that have been discussed in Ofgem's Regulatory Impact Assessment (RIA) on the interruption arrangements that might apply following the sale by NGT of one or more of its Distribution Networks (DNs).

As Ofgem is aware, SSE is supportive of the DN sale project. However, we are firmly of the view that only those changes that are necessary and expedient to facilitate a proposed DN sale should be considered as part of the DN sales project.

We are therefore most concerned that Ofgem has concluded that reform of the exit and interruption arrangements is required in order to enable a sale to take place. In our view, wholesale reform of the exit and interruption regime is not required to facilitate a DN sale. The only exit issue that does arise due to separate ownership of the NTS and DN assets is whether NGT, as owner of the NTS should be able to contract directly for interruption of sites connected to a DN. As a consequence, if Ofgem decide to pursue a programme of change that goes beyond these immediate needs, this would, in our view, be a disproportionate regulatory response, which could challenge delivery of the overall project.

In addition, we firmly believe that Ofgem's proposals under options two and three would add unnecessary complexity that would inevitably lead to additional cost (and risk) to market participants that will ultimately be borne by end users.

Notwithstanding these overriding issues, it is evident that the introduction of unnecessary change and complexity could undermine the cost benefit of a proposed sale and would seriously challenge the proposed timetable for a sale.

We have set out specific concerns in the attached paper. However, in summary:

- We do not believe that wholesale reform of the existing exit and interruption regime is necessary or justified;
- In any event, it is evident that reform is not a “gateway” issue to facilitate the sale of one or more DN;
- The only issue that does need to be addressed as a consequence of a potential DN sale is whether the NTS should have direct access to DN connected interruption for NTS capacity constraint management purposes;
- We are extremely concerned that a shift change from cost reflective exit charges to a market, or value based mechanism is flawed, would have an adverse impact on the exit arrangements, transportation investment, security of supply, competition and customers;
- We do not agree with Ofgem’s assessment of the costs and benefits of the proposed options for reform; and
- We therefore, believe that the status quo should be maintained.

If you would like to discuss any of the points we have made in this detailed response, please do not hesitate to give me a call.

Yours sincerely

Rob McDonald
Director of Regulation

SSE's detailed response to Ofgem's document "NGT Potential Sale of Gas Distribution Network Business – Interruptions Arrangements Regulatory Impact Assessment.

Introduction

Ofgem's proposals for reform of the exit and interruption regime is predicated on the perception that the current arrangements provide; (i) a cross-subsidy between firm and interruptible customers; (ii) inefficient investment signals arising; and (iii) lack of customer choice.

As we have set out below, we do not support these views and we do not believe that sufficient evidence has been provided to substantiate the claim that substantial reform as proposed by Ofgem is necessary. We are also concerned that Ofgem's proposal to move from the existing framework to a shipper/customer value-based framework is flawed on the grounds that it will not provide stable or long term investment signals to the network owners. It is also noticeable, although not acknowledged by Ofgem in this paper, that customers do not support Ofgem's proposals for a widespread reform of exit arrangements.

In any event, it is evident that Ofgem's concerns with the existing regime do not arise from NGT's proposal to sell one or more of its Distribution Networks (DNs). Therefore, reform of the existing exit and interruption regime is demonstrably not a "gateway" issue and should not be progressed as part of this process.

The only issue that does arise and which does need to be addressed as a result of a potential sale is whether NGT, as owner and operator of the National Transmission System (NTS), should be able to contract for DN connected interruption for NTS constraint management purposes.

Key Issues

We agree that the key issues that should be taken into account when considering the impact of reform are the economic and efficient operation of the gas transportation system, security of supply, impact on customers and impact on competition.

However, from previous consultation papers on exit reform and discussions with the industry and customers, we understand that Ofgem's proposal for reform is based upon its view that current arrangements:

- provide for a cross subsidy between different users;
- do not provide efficient investment signals; and
- restrict customer choice.

We address each of these in turn below.

1. <u>Cross Subsidy</u>

Ofgem believe that cross subsidies exist between firm customers and those interruptible customers that have not been, or are infrequently interrupted by NGT.

The Association of Electricity Producers (AEP) considered this issue in some detail in a paper submitted to Ofgem in November 2003 and concluded that, unless Transco has undertaken investment that is not directly related to meeting firm peak day demand, there is no cross subsidy from firm to interruptible customers. In coming to this conclusion, it is important to recognise that Transco's statutory duty to undertake investment in its system is related to meeting the 1 in 20 peak day demand for firm customers. It is also important to recognise that Transco is required to make sure that its charges reflect the cost of any investment incurred.

In other words, Transco does not invest in the system to meet the demand of interruptible customers and on days when the system experiences a capacity constraint, Transco is entitled to interrupt these customers in order to honour capacity holdings of firm sites. Since interruptible customers do not cause Transco to invest in its system it is reasonable, and indeed compliant with the duty to ensure that charges to customers are cost reflective, that these customers should not pay any capacity charge. The number of days on which they may be or are interrupted is completely irrelevant. We therefore do not support Ofgem's view that firm customers cross-subsidise those that are interruptible.

In our view, the only possible cross subsidy would be if Ofgem believes that Transco has invested in its system for reasons that are not related to meeting firm peak day demand and it is demonstrated that the cost of such investment should be borne equally by firm and interruptible sites. However, the RIA does not provide details of any physical capacity investment that has been incurred by Transco and hence of the cost which is "inappropriately" avoided by interruptible customers. We believe that this is a significant weakness in Ofgem's analysis.

Nevertheless, the evidence provided by Ofgem in chapter two of the RIA has focused on the number of days of interruption and how often it has been called. From this information, Ofgem has concluded that not all of the potential days of interruption have been called in recent years and, therefore, those that have not been interrupted are being cross-subsidised by those that are firm or interrupted more frequently. However, this ignores a fundamental point. The information provided does not relate to the amount of interruption that Transco would need to meet a one in twenty day and ignores the fact that interruption requirements are likely to be location specific. Particularly on the LDZ, there is very little substitutability between sites. At the exit capacity workstream meeting on 15 October 2003, Transco stated that in order to meet its obligations all the current interruptible loads were required for Transco to safely manage the system. We therefore question the accuracy of Ofgem's analysis and conclusions that Transco has over-contracted for interruption.

Given that the issue of cross subsidy is one of Ofgem's major concerns with the current exit and interruption arrangements, it is essential that this cost (i.e. the extent of a possible cross subsidy) is quantified. Only then will it be possible to judge whether there is a need to address the issue and how best to address it.

Ofgem is also concerned that the current arrangements are discriminatory to the extent that some locations may be more "interruptible" than others yet receive the same level of discount. Once again, we disagree with this view. Since no investment has been made to support the interruptible supply points it would seem appropriate that they are all treated equally. Indeed, we note that when selecting which site to interrupt, NGT uses an equitability algorithm to ensure that it does <u>not</u> discriminate between interruptible sites.

2. <u>Efficient Investment Signals</u>

We do not understand why Ofgem believes that the current regime prevents Transco from making efficient investment decisions. As we have described above, Transco's investment is based on meeting the 1 in 20 peak day demand for <u>firm</u> customers. Certainly, we have seen no evidence to suggest that Transco has not met this criteria, nor is there evidence to suggest that Transco's investment to date has been inefficient. In any event, we believe that there is already sufficient scope within the existing price control mechanism to address any possible inefficient investment decisions, and, therefore, wide scale reform of the exit regime is not required to address any inefficient investment decisions.

A further aspect of Ofgem's concern relates to inefficiencies that may arise in the event that a firm site subsequently elects to become interruptible and potentially therefore, assets become "stranded" or are "paid for" by remaining firm customers. However, in a workstream meeting earlier this year, Transco reported that the number of firm sites that have requested to become interruptible is minimal. This risk of standard assets does not therefore justify substantive reform.

3. <u>Customer Choice</u>

Ofgem is concerned that under the current regime a customer has no choice. We disagree. Quite simply, a customer does have a choice. It can choose whether to be firm and pay the appropriate cost reflective capacity charges or, alternatively, the customer can choose to be interruptible. If the customer chooses the latter, it does so in the knowledge that there is a likelihood that, on certain days, there is a risk of varying degree that it will be interrupted for constraint management purposes.

We also note that the current regime where by the customer has a choice of being firm or interruptible is consistent with Article 4.2 of the EU Draft Regulation On Conditions for Access to the Gas Transmission Networks (as at 16 June 2004) which states that "Transmission system operators shall provide both firm and interruptible third party access services".

Based on the above assessment of the three main issues that form the basis of Ofgem's proposals for reform, we do not support Ofgem's view that fundamental reform of the gas transportation exit arrangements is required.

<u>History of Reform and "Gateway" Issues</u>

As Ofgem has identified, the industry has been engaged in a debate as to whether reform of gas transportation exit arrangements is justified for some time. The current debate having been initiated by Ofgem when it first proposed universal firm exit arrangements, and by implication wholesale exit reform, as part of Transco's NTS System Operator (SO) incentive scheme.

Since then, the industry and major customer groups have invested a considerable amount of time and effort (and therefore, money) in contributing to the discussion and in seeking to understand Ofgem's concerns. It is therefore very disappointing that the RIA has singularly failed to justify the need for reform or acknowledge that the industry is united in its view that Ofgem's proposals for universal firm exit arrangements and the associated reform of the interruption regime, are not necessary or indeed, desirable. In our view, it is also particularly significant that major user customer groups do not support Ofgem's proposals.

However, most significantly, it is demonstrably clear that reform of the exit and interruption arrangements, as proposed by Ofgem, is unrelated to the DN sales process and should not, therefore, be a "gateway" issue. Indeed, it is evident that a reform of this nature could, in our view, undermine the deliverability of the project. It could also challenge the timetable for a DN sale recently proposed by Ofgem.

<u>NTS/DN Interruption</u>

The only interruption issue that needs to be addressed as a DN sale "gateway" issue is whether Transco, as owner of the NTS, should be able to contract directly for DN connected interruption for NTS constraint management purposes.

We are firmly of the view that the transmission operator should not be able to contract directly with DN connected sites for NTS constraint management purposes. Any activity of this kind would hinder the DN's ability to accurately forecast demand on its network and would, therefore, hinder the DN's daily operation and capacity balancing activities. We therefore believe that to the extent that DN connected interruption is required by the NTS, it should be provided by contractual arrangements between the two network operators.

In addition, during discussions in the DN sales workstreams over recent months, Transco has repeatedly stated that the NTS and DNs are run as totally separate entities. Indeed, this was one of the key arguments Transco used against having a broader SO that managed constraints across both the NTS and DNs (i.e. the "BETTA" model). We do not understand, therefore, why Transco now seemingly believe that there is a need for a direct relationship between the transmission operator and DN connected sites.

Ofgem's Proposals for Reform

We firmly believe that Ofgem's proposed options for reform of the exit and interruption regime raise considerably more issues than those that Ofgem believe are associated with the existing arrangements.

In particular, we are extremely concerned that Ofgem's options are modelled upon value based exit charging arrangements, rather than network cost reflective charges. We believe this approach is fundamentally flawed and will have a detrimental impact on competition and customers, the extent of which has not been adequately recognised by Ofgem in the RIA. We are particularly concerned that Ofgem stated at the CIWG that it favours the constrained allocation model. This not only contradicts the allocation methodology assumed by Ofgem in the Offtake RIA, but in our view, would be the most damaging of all of the options presented.

No Undue Discrimination

To avoid any claims of undue discrimination, exit capacity charges should reflect the costs incurred by the network operator in providing that capacity. A move to a universal firm exit arrangement whereby capacity charges are market based would, in our view, be discriminatory. Under this arrangement, transportation charges for existing interruptible loads would increase, the magnitude of which would vary depending on the location of the load on the network, in terms of incidence of network constraint and the proximity and activity of other "competing" loads. Therefore, future transportation charges would not only be uncertain, they would also be discriminatory depending on the location of the site.

Furthermore, it is evident that a change in regime of this magnitude would discriminate against existing interruptible loads that have modelled their long-term economic models on the current exit and interruption regime and associated charging methodology.

Efficient Investment Signals

Ofgem claim that the existing exit and interruption regime is inefficient on the grounds that no account is taken of the value that end users place on firm capacity and their associated "right" to have unconstrained access to gas. That is, rather than assessing the efficiency of investment against meeting security of supply and satisfying customer choice, Ofgem believes that investment "efficiency" should be judged against the value a user places on exit capacity. Furthermore, Ofgem believe that "market based signals of the value of capacity from users are more reliable and accurate than the information received through centralised planning processes alone as they are based upon firm commitments by market participants."

In supporting this view, Ofgem has cited the entry capacity regime as an example of a value-based market. However, no account has been taken of the fact that entry capacity commitments are backed and by firm, "fixed" financial commitments to long term upstream investment. Nor has it been recognised that at the majority of entry terminals there are a number of upstream shippers seeking to land gas at the same location whereas at specific exit points on the system there is no such long term commitment or level of "competition". In other words, the features of entry capacity regime are very different to those at exit and it is not, therefore, appropriate to compare the two "markets" in this way.

In considering Ofgem's proposals it is important to recognise that the perceived value of exit capacity will fluctuate depending upon a number of other fixed and variable costs and, in the case of most large users of gas, the future market value of their manufactured product. We therefore do not believe that loads would be in a position to effectively compete in a long-term, value-based market and if forced down this route, only short-term purchases of capacity would be made.

Accordingly, we do not believe that a market-based mechanism would yield any long-term investment signal for a primary exit capacity product. Nor do we believe that an efficient market would emerge for an interruptible secondary product. Information provided by Transco to CIWG in March this year demonstrated that within DNs, substitutability for interruption is very limited. This is because existing interruptible sites are located at the extremities of the network, loads in the same locality may not be on the same pressure tier and demand size may not be equivalent i.e. many smaller interruptible sites may be required to substitute for one large load. In addition, the development of a liquid secondary trading market would be severely limited by the fact that the capacity product would have a very low cost relative to the transaction costs of trading.

Ofgem's proposed options for reform would also require a shipper to buy sufficient long-term firm exit capacity to meet the aggregate requirements of its portfolio. However, in the competitive gas supply market, a shipper does not know how much capacity it would require years ahead since the level of churn within both the domestic and I&C market is significant and customers can change supplier (and therefore shipper) at relatively short notice. Therefore, under this proposal shippers would have to speculatively book capacity based on their best guess of the size and profile of their future customer portfolio. We do not understand why Ofgem could credibly believe that the aggregate capacity bookings of shippers facing such uncertainties would be more accurate than the single demand estimate of the networks owner.

We therefore fundamentally disagree with Ofgem that a market based on value would provide significant benefits to the economic and efficient network development of the network.

Security of Supply

We do not agree with Ofgem's assessment that a value based, market mechanism for exit and interruption arrangements would enhance security of supply. If all exit points were to become firm, there would be a significant security of supply issue in the short term to medium term since the network is not sufficiently robust to meet 100% firm capacity.

Furthermore, as set out above, we do not believe that the regime would provide efficient or economic investment signals which in turn would in all probability lead to issues associated with network planning and meeting security of supply obligations. Indeed, we note that the HSE's response to Ofgem's RIA on Offtake arrangements was opposed to the introduction of mechanisms that moved away from current arrangements in respect of determining network investment requirements.

<u>Complexity, Competition and Customers</u>

We believe that the complexity and regulatory risk associated with moving to a market, or value-based mechanism at exit would have a significant and detrimental impact on existing market participants and would act as a significant barrier to entry. Furthermore, the entry capacity regime has demonstrated that a market based mechanism to determine transportation charges is incompatible with a price controlled allowed revenue. Indeed, we believe that the measures that have been taken to deal with over/under recovery at entry has led to a distortionary re-cycling of money between market participants and the level of uncertainty created represents a further risk to participants. Together, therefore, rather than enhancing competition we believe that competition would be inhibited.

We also believe that the impact of Ofgem's proposals on customers has been underestimated. For example, the introduction of complexity and risk to a market is inevitably reflected in price. We therefore believe that the price end users pay for their gas will reflect the added risk that would be imposed on shippers if wholesale change to exit and interruption arrangements as proposed by Ofgem were to be introduced. This would be in addition to the increase in costs existing interruptible loads would bear in moving to a universal firm exit regime.

<u>Cost benefit analysis and assumptions</u>

Ofgem's cost benefit analysis has attempted to provide a qualitative assessment of the proposed options for reform. However, no <u>quantitative</u> assessment of the <u>cost</u> of Ofgem's proposals on customers, competition or security of supply has been provided. We believe that this is a significant omission and fail to see how Ofgem can justify reform without this information. In particular, we believe that the adverse impact of Ofgem's proposals on these key areas has been significantly under estimated by Ofgem in its qualitative assessment.

Ofgem has presented some information to support its view that a value-based approach would be more efficient than existing arrangements in determining efficient investment decisions. Ofgem claim that the benefit of the value-based model compared to the current process in terms of short run efficiencies is £1m/yr, and in terms of long run efficiencies, a value-based mechanism would yield a benefit to customers of at least 3% of capital expenditure per year. We believe these numbers are questionable, but clearly, Ofgem's assessment of short run efficiencies does not justify a wholesale reform. We also see no evidence to support Ofgem's assessment of the perceived long term efficiencies. In particular, no evidence is provided to justify the assumption that a value based mechanism would lead to a saving of some 3% capex per year.

Together therefore, we do not believe that the information presented in the cost benefit analysis is in any way sufficiently robust to support Ofgem's claim that the benefits of Ofgem's proposals for the reform of the exit and interruption regime would outweigh the costs.

Conclusion and Way Forward

Having considered the options for reform that have been proposed by Ofgem in the RIA and the associated cost benefit analysis, we do not believe that there is sufficient evidence to support wholesale reform of the exit and interruption arrangements. It is demonstrably clear that wholesale reform of these arrangements is not required in order to facilitate a sale of one or more DNs. The only issue that does need to be addressed in this respect is whether Transco, as owner of the NTS, should be able to contract directly for DN connected interruption for NTS capacity constraint purposes.

In any event, even if it were to be proved that the issues with the current regime identified by Ofgem do actually exist, the options that have been proposed by Ofgem in respect of a constrained allocation mechanism are unnecessarily complex and disproportionate. We also believe that a move from a cost reflective charging methodology to a value based mechanism is fundamentally flawed and will have an adverse effect on the network investment and development of the gas transportation system, security of supply, competition and customers. We also believe that the quantitative cost benefit analysis that Ofgem has presented in the RIA to support the proposals is inadequate.

We therefore conclude that the status quo should be maintained and the requirement to introduce universal firm NTS exit capacity arrangements should be removed from Transco's price control. To the extent that any reform is subsequently proven to be necessary, this should be addressed through introducing measured, incremental change.

SSE
28.07.04