National Grid Transco – Potential sale of network distribution business

United Utilities

Response to Regulatory Impact Assessment - Interruptions arrangements

Introduction

United Utilities welcomes the development of this RIA by Ofgem as part of the consultation process on the sale by NGT of some of its DNs.

We note that this RIA focuses on high level principles. Ofgem acknowledges that significant work remains to be done to develop the options before any final decision can be made as to the best method of reforming the current arrangements. We agree that this is the case. Correspondingly, whilst we agree with Ofgem's conclusion that reform is desirable and that more effective arrangements can and should be put in place, we do not believe it is appropriate at this stage to commit to any one particular option. Rather we highlight our position in respect of certain fundamental principles and identify areas that we believe require further investigation.

In overview, it is essential that the right incentive mechanisms are in place for DNs to ensure that allocation decisions are efficient and, in the medium term, minimise the cost to end consumers. We will continue to work with the CIWG and the DISG to help Ofgem develop workable and efficient solutions.

Market Based Terms

We agree that there should be freedom to contract on market based terms. There should be no obligation on a network operator to offer interruptible contracts to a site where interruption has no operational benefit to the network. This makes no sense on the grounds of economic efficiency and, as Ofgem has indicated, potentially creates unfair competition and barriers to entry in the retail market.

We also agree that consumers should not be required to contract on an interruptible basis if they do not wish to do so. However, as Ofgem recognises, there may be a short term issue where particular constraints on a system would give individual consumers/shippers undue market power. It is important that this short term threat is addressed and, whilst we appreciate that Ofgem has significant powers under the Competition Act, we believe that there is merit in exploring the option of a price cap.

Constrained versus unconstrained allocation

We confirm our opinion, expressed in our response to the Offtake Arrangements RIA, that it is preferable to adopt an unconstrained approach to the allocation of capacity rather than a constrained one.

We believe that an unconstrained approach has the merit that participants can book and pay for the capacity that they require. In contrast, we are concerned that any system of unconstrained allocation will necessarily contain arbitrary rules that do not reflect market requirements. Faced with a set of allocation rules, shippers will request not the level of capacity which they require but the level which under the allocation process is most likely to deliver their genuine needs. In addition, the nature of their business is such that it is difficult for them to make long term commitments. Consequently we do not expect the regime to generate the additional economic and efficiency signals which Ofgem identifies in the cost benefit analysis.

Arrangements for allocating constrained capacity could also be extremely complex. This will place an additional burden on the industry which consumers will in the end need to fund.

In view of these considerations, we are concerned that a constrained approach is being seriously considered for adoption while there currently appears to be no clear view as to how the allocation would work in practice. We believe that there is an urgent need to demonstrate that the drawbacks we have set out can be overcome before the option is taken any further.

We recognise that there are also potential drawbacks to an unconstrained approach. In particular we recognise the potential for participants to manipulate capacity bookings. We believe it is important that there are adequate measures in place to prevent this. However we believe such concerns are less serious those that arise under constrained allocation and that the concerns can be addressed by a combination of powers under competition legislation and direct regulatory oversight as required. The regulatory burden of this is likely to be substantially less than that of a constrained allocation regime.

We also recognise that there will need to be further consideration of the status of Network Sensitive Loads under an unconstrained approach.

Options on interruption

Our general comments on the options for interruption are:

- Whatever option is adopted we believe it is essential that the network owners retain control of interruption.

- The more information that the DNs have the better they will be able to make efficient investment decisions.

- Given the lead time on infrastructure it is desirable to have in place a number of long term agreements for interruption.

In theory therefore we see benefits in both options 2B and 2C. Option 2B provides more information and operating choice than the simple matrix proposed under Option 2A. Option 2C will provide more information and choice but combined with the matrix may enable customers to participate who would not have been prepared to take part in a tender process.

We note that where a matrix is specified it will be important that the structure of charges in the matrix reflect the network owners' costs. The balance between the "option fee" and "exercise fee" is of particular relevance here.

Importance of incentives

Clearly a critical area for any network owner will be the regulatory incentives which will apply to ensure the correct balance between interruption, investment in infrastructure and other activities that the DN may undertake. The relationship between the interruption scheme and regulated revenue will thus be critical to encouraging efficiency. We note that at this stage the RIA does not attempt to consider these incentives.

It will also be important to ensure that the relationship between DN and NTS interruption is such that there are efficient signals for both the amount of available interruption that is contracted for and the amount of interruption that actually occurs. In this and in other areas the interruption regime is related to the offtake regime. In particular, issues arise both of non-discrimination and efficiency. Satisfactory resolution of issues on interruption is likely to require satisfactory resolution of issues on off-take. Again, we note that the RIA does not attempt to consider this issue.

Participation issues

Whilst the above options, if working in the manner envisaged in the cost benefit analysis, should deliver Ofgem's and our objectives and address many of the key issues, we do have some concerns as to how they would work in practice.

In essence our concerns are with how willing shippers and consumers would be to participate. Clearly this is not our area of expertise but we are aware from discussions at CIWG and DISG that there appear to be significant reservations.

Comprehensive detailed processes can provide useful information and create a potentially optimum investment and operating regime. However if the complexity of the process actually deters some or many participants from taking part then the value of the information is severely diminished and a less efficient investment and operating regime may result compared to the situation if a simpler process is adopted. As noted above, long term commitments to interruption will be highly desirable in terms of making investment decisions. However given that a consumer's willingness to accept interruption is dependent on many factors outside of his control, in particular the price of alternative fuel and the general economic climate, we wonder how prepared consumers will be to make long term commitments at attractive prices. We look forward to seeing the views of shippers and consumers on these issues.

Developing a system which gets the balance right between information and participation and which encourages long term commitment is one of the key challenges facing the work groups over the coming months. We look forward to working with Ofgem and the rest of the industry to meet this challenge.