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

Dear Sonia,

National Grid Transco – Potential sale of gas distribution network businesses – Interruption arrangements – Regulatory Impact Assessment – June 2004 – 146/04

I am writing to offer views on the above document on behalf of our 180 members in the UK. As you know we have a strong interest in gas matters. The chemical sector is the largest manufacturing user of natural gas, consuming about 5% of all UK supply.

Background: CIA has taken an active role in the discussions that have taken place on reform of the gas exit regime over the last three years. I have devoted considerable resource to the various Transco work streams and also served on your predecessor's advisory group, the "ERAG"; and followed carefully the work on the exit regime carried out by the Commercial Interfaces Working Group.

The RIA Document: We have studied the present RIA in some depth. Our analysis has resulted in a number of observations, which I summarise below, though I would be glad to expand on them at greater length. We believe that analysis would need to be developed considerably in three key areas before the data could be used by the Authority to form any considered view about whether reform is required:

First: the overall philosophy and arguments presented. Reading the RIA does suggests that Ofgem's arguments remain largely the same. However, good arguments also remain for no, or piecemeal reform, but these, though acknowledged, appear to receive minimal presentation in the document.

Second: Analysis of the current interruptions regime. Reading the data on frequency of interruptions presented in chapter two, a reader would anticipate a test of assertions such as the one that the present regime contains "free riders". However, after demonstrating that only a small amount of Transco's potential interruption in recent years has been used, the analysis seems to fizzle-out in concluding that "that this outcome is consistent with the recent series of mild winters in great Britain". This appears to leave questions about how much interruption Transco currently contracts for, and whether it has too much, largely open.

Third: The assumptions and the need for sensitivity analysis. We believe that the appendices contain the main items of genuinely new work in the document. We have the following observations on the cost benefit analyses presented in appendix one.

Short run efficiencies. This begins reasonably by pointing out the problems in Transco's "equal misery" approach to interruption, and demonstrates that if Transco adopted a type of merit order approach by first interrupting sites for whom interruption was less costly, then the overall costs of interruption would be lower. We accept this analysis as far as here, but believe that the extrapolation that follows would need considerably more development to be sound.

We understand the extrapolation to be broadly as follows. First, Transco's "equal misery" and an imaginary "cheapest first" algorithm are compared on the basis of an assumed cost of interruption to consumers. The assumption is made (we agree correctly) that cost differences would only come into play in a severe winter when many consumers are being interrupted. Given that mild winters are similar the difference in costs to consumers is estimated as £1m a year, which can be discounted to an NPV of £12. It is then further assumed that the RIA's options for market type arrangements might deliver an assumed percentage of this NPV to Transco. The benefits computed, at the end of this, rely therefore on a string of assumptions being accurate. An error in any one of these could result the end benefits being considerably wide of the mark.

For example, it is quite feasible that under the conditions of a severe, or very severe, winter, when the cost difference upon which the entire analysis relies would come into play, that savvy consumers contracting short term to sell interruption services to Transco would offer these at a going rate, and moreover, a high one – rather than simply a price reflecting their opportunity costs. A 25% premium, for the reasons cited above, on the cost of interruptible services (offered to Transco), in infrequent severe, and very severe, winters would be enough to reduce the annual £1m benefit and the NPV to zero, whereas a 50% price premium, again for the same reason, would create a net loss of £1m and turn this part of the analysis on its head.

Long run efficiencies: This section presents an analysis, which suggests that Transco over contracts for interruption – only using about 5,900GWh of a possible 31,500GWh, even in a severe winter. We question the validity of this analysis. For example the 31,500GWh which Transco contracts for is most likely the product of total GWh gas that Transco could interrupt in any one day, multiplied by the 45 occasions, or days, when it has the option to do so. It is reasonable to say that even in severe winters it will never interrupt all interruptible sites completely, throughout all the days that it has the right to do so. Therefore it is never likely to use the maximum theoretical amount of interruption that it contracts for. To say that this is therefore a flaw in the present arrangements though, fails to view the arrangement for what it is – an insurance of a locational nature. Transco presumably needs to hold all sites in reserve for the worst day, even though many of them might not be called to interrupt, because it does not know in advance where in the country interruption might be needed. The analysis presented in the appendix is analogous to saying that a traveling businessman has European insurance cover that allows him to claim a maximum of £10,000 for lost luggage in any EU country, and who (owing to a severe theft) does claim the maximum, has over-contracted for insurance: because he is theoretically covered for £250,000 of lost luggage throughout the EU 25!

Regardless of whether it is reasonable to state that Transco over contracts for interruption or not, we question the estimates the made of what this inefficiency might be worth. It is based on an assumption that the inefficiency manifests itself as extra capital expenditure worth 3% of all network capital expenditure presently spent. While accepting that such intangibles sometimes cannot be quantified more accurately than an informed estimate, we question why this figure in particular is justified. Why not 2% or 4%? Again relatively small changes to this assumption would have large impacts on the NPV figures presented, and ultimately on the overall net benefits shown in the executive summary. As an example of a sensitivity, a reduction of 1.25% in this assumption, i.e. that the inefficiency is only worth 1.75% of capital spent, rather than 3%, would reduce the NPV associated with removing this efficiency, under option three, by £20m. A change to this aspect alone then would reduce the overall net benefit of option three – apparently the most compelling number for reform – to close to zero.

Costs of implementation and administration:. It is difficult for us to add any meaningful commentary to the numbers shown other than to say that we believe that in any branch of estimation it is a natural trap to under-estimate the costs associated with significant changes to regimes. We note that the extra administrative costs to customers, an issue raised by CIA members, have not been included and discussions on this topic with various shippers give us a consistent, if anecdotal, picture that the costs may be underestimated.

Conclusion:

- As you probably know, the position of CIA members throughout the period of discussing exit reform has been broadly "if it ain't broke, don't fix it". We accept there are some valid arguments for reform, but given the lack of appetite within the industry for it, *we believe that option one – no change – remains the most sensible choice*. We have set out the reasons that underpin this position several times before and, for background; I attach an article published last year in Oxera's *Utilities Journal,* which summarises CIA's views.
- Though a case could be made for reasonable and cautious piecemeal reform, providing it were steered by the industry, we do not believe that there is, in general, any case for more radical reform.

- We do not believe the document presents a compelling case for any of the reform options; and especially not the more radical reforms, such as option three, where the costs and benefits are likely to be much more uncertain.
- With regard to the RIA itself, it seems unusual, though not wrong, that a high level quantitative analysis should appear at this stage in the debate, when both the regulator and industry appear to have become entrenched in their positions. Without wishing to demean or trivialise the genuine new work that appears in this document, we question the effect that the emotive nature of the debate over the last few years, may have had on the objectivity with which assumptions in the RIA can, and have, been made. Given the raft of assumptions that underpin the final numbers, we wonder whether very different, though no less reasonable, numbers might have appeared from an industry led version of the same exercise.
- We would like to re-stress the large number of assumptions on which the executive summary depends, and the ease with which small changes to these could turn the analysis on its head. We believe that before the Authority could make any considered judgment on the case for reform that a full sensitivity analysis would have to be conducted along with a much more rigorous testing of the assumptions.

In summary, we do believe that progress can be made in this debate, but that it must be on a consensual basis. We find the very entrenched positions that now seem to have developed between a regulator keen for radical reform, and an industry that appears not to want it, very difficult to continue to play a constructive part in.

I am sorry that I cannot be more positive about the case that the RIA tries to make for reform. We hope to continue providing input to this debate in as constructive a manner as possible and I would be glad to expand further on any of the points in this letter.

Yours sincerely.

Rob.

Robert Siddall.
Head of Group,
Competitiveness and Utilities