Direct line: 020 7752 2200
Fax number: 020 7752 2128

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

Date 28 July 2004

Dear Sonia

National Grid Transco – Potential sale of gas distribution network businesses: Interruptions Arrangements

Thank you for providing EDF Energy with the opportunity to respond to Ofgem's Regulatory Impact Assessment (RIA) on interruptions arrangements relating to the proposed distribution network (DN) sale. We agree with Ofgem that one of the objectives of the process is to consider whether the interests of present and future customers are protected.

EDF Energy does not support any amendment to the current interruptions arrangements within the timetable for the proposed DN sales project and we believe that Option 1, the status quo, should remain. We do not believe that the case for change has been made from the cost benefit analysis and there is not sufficient time to develop a legally and operationally robust solution. Furthermore, the options proposed represent complex mechanisms that are not guaranteed to deliver economic efficiency. On a general point, we do not believe that reform of the interruptible arrangements is a requirement for the proposed DN sales. Discussions under Transco's exit and capacity workstream have not been able to determine an appropriate new interruptions regime throughout the 18 months of discussions.

EDF Energy has noticed that this RIA does not reflect the minutes of the Commercial Interfaces Working Group (CIWG), nor has the CIWG had the opportunity to approve the format and content of the RIA, which we have found is the normal process for impact assessments. We would like to ensure that any future RIAs are reviewed and approved by the relevant work group.

We do not believe that Option 2 or Option 3 would correct any perceived deficiencies or generate allocative efficiency. Any amendments to the current

regime in the short timescales required by the DN sales project would represent an enormous task, and would entail an increase in costs to shippers with unknown benefits to the market. EDF Energy would like to point out that perfect competition does not exist in interruption due to the existence of network sensitive loads (NSLs). We note that Ofgem has powers under the Competition Act to address any potential abuses of locational market power, but this would lead to increased regulatory involvement and potentially lengthy investigations.

EDF Energy has followed the assumptions in the cost benefit analysis and note that NSLs have not been included in the modelling of the Net Present Value (NPV) for any of the options. EDF Energy is aware that there are just over 170 NSLs in DNs which represent 26% of the interruptible capacity in the DNs in terms of supply point offtake quantity. If Ofgem is seeking to reduce the amount of interruptible capacity, then the share taken by NSLs may increase. We believe that any model of the interruptions arrangements should include NSLs as they represent an important segment of the market. Including the costs of interruption from NSLs may remove any NPV benefit relative to the current baseline (option 1). As noted from Transco presentations to the exit capacity workstream, NSLs may have a higher probability of being interrupted, particularly during mild weather conditions, than other sites.

Table 1 below shows the potential saving from efficient investment signals. If we look at the entry capacity auctions, it can be observed that shippers tend not to buy entry capacity more than three years ahead. This could indicate that no extra capacity is required, but it could also mean that the entry capacity auctions do not deliver long-term investment signals. While investment signals are useful, we do not believe that market participants are willing to procure interruption more than three years ahead. Therefore, we believe that it is difficult to determine any cost benefit associated with efficient investment signals. If we remove any efficiency gain from long-term signals we can see that the implementation costs outweigh any benefit. We note that this is just one way of looking at the cost benefit analysis; however, as this model does not include NSL, it does not represent the market and we would request that Ofgem reconsider its analysis before making any policy decisions.

Table 1	**Option 2A**	**Option 2A***	**Option 2B**	**Option 2C**	**Option 3**
Efficient investment signals	£34m	£17m	£34m	£34m	£50m
Efficient system operation decisions	£9m	£2m	£12m	£11m	£12m
implementation and admin costs	£-31m	£-31m	£-28m	£-33m	£-40m
Total NPV relative to option 1	£12m	£-12m	£22m	£12m	£22m
Total NPV (not including investment signals)	**£-19m**	**£-28m**	**-£16m**	**£-20m**	**£-28m**

EDF Energy has concerns regarding the implementation of any matrix or tender process in view of the number of supply points that could be potentially involved. Options 2 and 3 will present a cumbersome and complex process for shippers, customers and Transco.

EDF Energy believes that it is important to ensure that any proposed option is compliant with the relevant EU directives and regulations. The industry has already given a significant amount of resource to the interruptions arrangements

and it would be damaging to the industry if any solution were not compliant with these instruments.

Option 1: Status quo
EDF Energy notes that under Option 1 there would be minimal, if any, implementation and administrative costs. There have been only two cold winters in the last 15 years (recent ILEX presentation). So it is hard to determine whether the current level of interruption is sufficient to meet a 1 in 20 severe winter condition. We note that Transco has provided data to Ofgem which states that they have ample interruption to meet a 1 in 20 obligation; however, Ofgem has not seen nor tested the assumptions behind the volumes required and we request that this analysis and its assumptions be reviewed. EDF Energy supports this regime going forward for the potential DN sales.

Option 2: Unconstrained allocation of the firm capacity product
Under this model shippers would be able to book all the capacity they require through either tenders or a matrix approach. We note that Transco believes that this model is consistent with its universal firm licence requirement. However, supply points can still be interruptible under Option 2 and we would like Transco to clarify how this methodology represents universal firm. Generally, option 2 will introduce a more complex regime for Transco, shippers and customers, which will result in additional costs.

EDF Energy does not believe that Option 2 will provide long-term signals and notes that Ofgem agrees that "it is likely that most booking of capacity would continue on the same time horizons as now."

EDF Energy does not support the implementation of Option 2, as the current baseline represents the optimum mechanism for the interruption arrangements. However, Option 2A*, the simplified pure matrix approach, represents the least complex approach. Under this option, shippers and customers would not be able to receive different signals from different customers for a given number of days. On the other hand, there would the opportunity to determine the number of days of interruption they were willing to offer. We would like Ofgem to note that this option does not require universal firm capacity allocation and would allow customers to indicate their preferred duration of interruption against a predefined matrix of costs.

Option 2B would require Transco to tender for interruption with shippers in respect of a particular supply point. Again, this would represent increased resources on Transco, shippers and customers to determine the number of days as well as option and exercise price. Furthermore, shippers tendering for DN interruption may actually raise the cost of interruption, as it will reflect their costs incurred due to outage rather than the cost of avoiding payment for firm charges.

Option 2C would run both the matrix and tender approach alongside each other and Ofgem has noted that the presence of a matrix process could potentially distort bidding behaviour in the tenders. Ofgem has suggested that tenders could be used to allocate long-term interruptible rights and the matrix approach

to allocate one-year interruptible rights. Shippers would be required to adopt different processes for long and short-term capacity bookings and this would represent a very complex hybrid situation. EDF Energy believes that no shippers would tender for long-term interruptible rights and that Option 2C would resemble Option 2A (the matrix approach).

Option 3: Constrained allocation of the firm capacity product

Even though there is no mention of auctions in Ofgem's RIA, we believe that Option 3 is proposing auctions for exit capacity. EDF Energy does not support auctions for interruptions as they will not provide more long-term information. Shippers do not have long-term information on their exit capacity requirements, so both Option 2 and Option 3 are hoping to reveal signals that do not exist in the market. Shippers cannot provide long term signals, as it is difficult to get financing for products over 3 years ahead, as the price is subject to change. Furthermore, looking at the entry capacity auctions, there has been increased regulatory input required and complexity due to the process that needs to be managed and the documentation required to support the process, for example, Incremental Entry Capacity Release methodology and calculation of Unit Cost Allowance. Auctions can also lead to under/over recovery against allowed revenue, and any revenue redistribution mechanism may create cross subsidies between network users. The granularity across Exit Points would lead to a very large IT investment on behalf of Shippers, and possibly interested customers, which would make entry into the Gas Market prohibitive.

Transitional arrangements

We note that Ofgem has discussed the transitional arrangements to address the potential for abuse of market power, whereby a cap would be introduced to set a maximum that a site would be allowed to recover from the network owner in a interruptible contract. However, any caps represent a form of market intervention and would not allow the true price signals to be derived from the market and hence does not represent a true market. We agree with Ofgem that placing price caps on interruption contracts in the gas market may inhibit appropriate development of the gas network.

Cost Benefit Analysis Assumptions and Methodologies

EDF Energy notes that quantitative assessments are difficult and we welcome the invitation to comment on Ofgem's assumptions.

EDF Energy has severe concerns that the model of the interruptions arrangements has not included NSLs, which represent 25% of the interruptible capacity in the distribution networks. We believe that Ofgem should model the market including NSLs to determine if there is any NPV benefit from changing the interruptions arrangements.

We note that the assumptions behind Transco interruptible capacity requirements for a 1 in 20 winter are not included in the RIA and have not been checked by Ofgem. We request that this information be made available to market participants and verified by Ofgem.

We note that the percentages in Table A1.5 under the proportion of maximum benefit are subjective and determine the values related to efficient system operation decisions. The percentages in Table A1.7 for percentage improvement in capex are also subjective and have a large influence on long-term efficiencies. The values assigned to the efficient investment signals and efficient system operation decisions are subjective, and EDF Energy believes that the case for change has not been made. A full analysis of the interruptible market including NSLs is required as well as the presentation of a number of scenarios using different costs for high, medium and low cost customer classes, and different percentage values for the proportion of maximum benefits and the improvement in capex.

I hope you will find these comments helpful. If you would like to discuss any of them, please contact Helen Bray on 020 7752 2518, or myself.

Yours sincerely

Denis Linford
Director of Regulation