Ofgem's Initial thoughts on enduring incentive schemes supporting the offtake arrangements Comments from the Association of Electricity Producers

10 March 2005

The Association of Electricity Producers welcomes the opportunity to comment on this initial thoughts document, however we continue to believe that the proposed offtake arrangements are unduly complex and unnecessary. We are also concerned that costs to customers will increase and that transportation charges will become more volatile. Whilst we provide comments to the questions raised, we would not wish this to be taken as support for the proposed offtake arrangements.

The Association is broadly supportive of the proposed incentive structures, utilising the usual target, cap, collar and sharing factor approach, but recognises there is much work to be done to consider the appropriate values of these parameters.

The Association is concerned that this document does not address a number of issues where there appear to be inconsistencies or unresolved issues with respect to Transco's business rules that could undermine the incentive arrangements or materially affect the way in which the regime works. These issues will, in turn, influence the baseline options that might be preferable or indeed most efficient. We consider that, without further clarity on these issues, we are unable to express a view as to which baseline option would be most appropriate. These include:

- Limitation on trading into a location to the baseline level
  - Where baseline quantities are set to zero or any value below the existing SOQ of the offtake, limiting trading into a location up to the baseline will prevent these offtakes sourcing capacity by trading. Their only option will be to secure their full requirement from Transco in the long-term capacity allocation. Sites that have the baselines equivalent to or greater than their existing SOQ can source their capacity by a combination of long, medium and short-term allocations or by trading as long as their baseline is not reduced by substitution. This difference in approach seems neither fair nor equitable and may not result in efficient outcomes.

- Quantity of interruptible capacity at the day ahead stage
  - Ofgem's document notes that there will be an interruptible product made available at the day ahead stage, but does not comment on the quantity of interruptible capacity that will be made available. Transco's business rules only contemplate releasing a UIOLI product at the dayahead stage. The Ofgem Final IA suggested that the release of interruptible capacity at the dayahead stage would be unconstrained.
  - The AEP has previously stated that it does not consider a UIOLI product to be a true interruptible product rather a 'proxy' firm product as it is only made available where firm capacity has been purchased. We consider there is an important difference here between the arrangements at entry and those proposed at exit since at most offtakes there will only one or few purchasers of capacity whereas at entry there are many purchasers.
  - We also consider that the provision of a UIOLI service will not be sufficient to ensure compliance with the EU gas regulation on access to gas networks that requires TSOs to provide firm and interruptible services.
  - We also consider that the provision of interruptible capacity on an unconstrained basis day ahead will assist in ensuring that all available

capacity is made available to the market and be consistent with the provision of security of supply of gas and electricity markets.

- Whether there will be a registration process at all offtake points
  - Transco's business rules at the time of its consultation only contemplate a shipper registration process at some types of offtake points. We consider that a registration process should be in place at all offtake points, particularly direct connects so that the customer can influence which shippers can purchase capacity at their offtake and can through appropriate commercial arrangements secure the capacity rights they require. It is difficult to see how customers are protected in the absence of a registration process, since opportunistic purchases by shippers with no direct relationship with the site could prevent the 'real' shipper from securing capacity at a cost reflective price or even provide spurious investment signals to Transco.

- Whether unsold baseline capacity will be available within day
  - Transco's business rules consider that Transco will have discretion in the capacity released within day but that unsold baseline will only be made available day ahead. Ofgem's document suggests that that unsold baseline could be made available within day too. We consider that there should be a within day release of capacity as well as a day ahead release, this is particularly relevant for offtakes that use the NTS for back up supplies only and for sudden changes in demand. Clearly there will be interactions with the trading rules here too.

We are also concerned that this document does not consider the baselines for flow flexibility for each offtake point. Since we expect these to be defined in the licence we would have expected this initial thoughts document to present initial values for these as presented in Appendix 1 for NTS exit capacity baseline values. As a consequence of this, these values will be subject to less consultation than the capacity values and this is a matter of some concern.

We now provide comments on the specific issues raised in the consultation document.

<u>The proposed form, scope and duration of the NTS and DN enduring incentives</u>
We broadly support the form of the proposed incentives. We agree that a duration of five years is appropriate and with the principle of a re-opener for recalibration if necessary. However we would welcome some clarification on the triggers for recalibration and would expect these to be established transparently. We also do not fully understand the timing of any recalibration, since year one would need to have finished before the final incentive outturn was known and before any reassessment could begin. Given the required timing of the consultation process and licence modification any new values could not be applied prospectively to year two. We would welcome further clarification on how this might work in Ofgem's initial proposals document.

We agree with the proposal for a three year test for sustained demand, this would bring transparency to the release of incremental capacity

We consider that the concept of a clearing allocation is important in ensuring that capacity is made available to the market and in principle would support this also being applied to NTS exit capacity and flow flexibility. However we are sceptical whether this would achieve the

expected outcome. Given that there may only be one party at most offtake points there will be no competition for capacity or flow flexibility at these offtakes hence Transco could and would argue that given its wider licence obligations it would not be appropriate for it to have to comply with this requirement, which could give rise to a substantial under-recovery of revenue.

Methodology for determining baselines for NTS exit capacity and flow flexibility

The Association supports the nodal approach to setting of baselines for both NTS exit capacity and flow flexibility.

We note that this document does not discuss any options for the setting of baselines for flow flexibility. We consider that the baselines should be set in a manner consistent with the flexibility currently available on the system but we are unable to comment further on this .

The Association is concerned that the industry is being asked to consider baseline options in the absence of any information on the magnitude of the buyback targets that would accompany each option. We would expect option one through to four to require increasing buyback funds and possibly larger caps and collars. Hence Transco may have the potential to earn greater incentive revenues under option 4 than under option 1 although its actions in response to the incentives might be similar. As incentive revenues to Transco are ultimately funded by customers through transportation charges, the absence of full information concerning the proposed incentives including the level of the incentive targets might lead to shippers and customers opting for option 4 which could given them access to 'more than enough' capacity whereas more complete information concerning the potential costs of this could lead them to opt for a different option.

The Association is also concerned about a simple parallel being drawn with the entry capacity arrangements. Firstly we accept that the maximum physical definition at entry helped to alleviate the issues that arose from the previous SND related definition. At entry the major terminals have several shippers with each wishing to hold capacity to cover its expected flows even though in practice these flows could not occur simultaneously, therefore it is logical to set baseline levels above what can actually be delivered at anyone time to provide this headroom. At exit only a few offtake points will have more than one shipper purchasing capacity hence there will be no need for the extra headroom above what can actually flow on either a network or an offtake specific basis. The multiple vs. single capacity holder at an offtake point will also create issues when Transco needs to buyback capacity as at exit it will often only have one party to buy capacity from. Also buybacks at exit are likely to be in the winter whereas at entry they are more likely to be in the summer or shoulder months which could have cost and incentive implications. Hence we would be very cautious in suggesting that the same principles that apply at entry should apply at exit, this may be appropriate but the consequences require further detailed consideration.

Baselines: constant or increasing over time

Following on from the comments above we note that the baselines at entry increase over time, although at this time it is not clear that this will continue at the next price control review. Whether the baselines at exit need to increase over time may depend on which option for the baselines is chosen, clearly if option 1 is chosen, it would seem reasonable that the baselines should increase to ensure that transporters could meet their 1 in 20 licence obligations. If option 4 is chosen then this would be less of an issue. Although simply increasing each baseline by a given amount for each DN offtake may dilute the incentives on the DNs to find the most efficient solution, not only by substituting investment between the NTS and DN but also between specific DN offtakes. It is less clear that it is necessary to

increase the baselines over time for the direct connects and other non-DN offtakes. Their requirement for additional capacity will only arise when there is additional investment in the plant consuming the gas (or interconnector or storage facility). Hence increasing the baselines over time would appear to give rise unnecessary large baseline numbers and in the longer term could mask genuine investment signals. For example baselines might increase sufficiently such that incremental investment in gas consuming plant does not need to signal the need for additional capacity and if the metering equipment is of sufficient size the offtake could just buy the additional firm capacity in the short term, with no other communication to Transco such that it would have very little notice that the capacity was actually going to be used and this could create operational difficulties.

If a different approach was adopted for direct connects and DN offtakes then this would be inconsistent with the aim of treating all offtakes in the same manner and could be discriminatory, but treating the offtakes in the same manner could also give rise to some undesirable effects.

It is also important to understand how Transco will comply with its 1 in 20 licence obligation, whether this will be linked to expected offtake under 1 in 20 conditions as it is now or will be refined to take account of long term capacity bookings with long term buyback offsetting. We would welcome some clarification on this.

Indicative baseline numbers

The Association considers that in setting baseline values it is important to strike a balance between the needs of customers, the costs they will face and the desire to provide clear signals for investment to ensure efficient and economic system operation.

Given the absence of full information regarding the incentive package the Association does not provide a view as to which option it favours, but comments are provided below.

- 1) Forecast 1 in 20 demand
  - These baseline numbers most closely reflect Transco's obligations to meet 1 in 20 demand with the assumption that all interruptible plant would be interrupted on the peak day. No account is taken of the utilisation of the same assets for the rest of the year.
  - Existing interruptible sites have a zero baseline and will therefore need to secure firm capacity in the long term auctions at incremental prices, whereas current firm sites will have some choice over the timescale in which they secure capacity rights, as long as their baseline in not reduced.
  - Existing interruptibles will face a step change in their capacity costs
  - Existing interruptibles will not be able to secure additional short term capacity by trading as trading into a location is limited to the baseline quantity, as explained above, this could place their business at risk if they mis-judge their long term bookings.
  - Existing interruptibles have less optionality in their capacity bookings than firm sites
  - We would expect this option to have to lowest buyback cost target.
  - Transco should receive a clear investment signal for the firm capacity requirements for the current interruptible sites, but it is unclear as to whether this will result in actual investment given that the capacity is available most of the year.

- 2) Forecast 1 in 20 demand plus interruptible volumes
  - These baseline numbers are in excess of the current network capability at peak conditions. It would be unwise to assume that existing interruptibles will

be willing to enter into long or short-term buyback arrangements with Transco. Therefore significant network investment may be required in order for Transco to meet the theoretical demand for capacity under peak conditions if all offtakes required capacity simultaneously. It is not clear what incentive arrangements would apply to this investment or how it would be funded.

- Ofgem considers this definition is ambiguous, as it is not directly linked to the physical capacity of the network. We would not expect customers to consider this view to be ambiguous as the baseline would be set at their current SOQ and therefore fully able to meet their needs.
- This universal firm approach addresses the trading into a location issue as identified above and also provides existing interruptible sites with the same optionality as existing firm sites.
- As all offtakes will potentially be able to secure baseline capacity at the dayahead stage or even within day, Transco will have little information to plan its investment or daily operations and this could lead to inefficiencies.
- Interruptibles will be able to secure firm capacity at the UCA rather than incremental cost, this may be more favourable to the customer
- We would expect this approach to require a larger buyback fund than option 1.
- There might be more substitution under this approach

- 3) Practical maximum physical capacity
  - This approach allocates any additional network capacity over and above 1in 20 requirements (option 1) to individual offtakes. We expect this additional capacity to arise from 'lumpy' investment, so the question appears to be should this be allocated to individual offtakes or should Transco retain this capacity and potentially receive investment revenue in the future for investment decision made in the past? The benefits and risks of this are unclear
  - From a customer perspective the numbers are ambiguous since they derive from complex network models and not the capacity defined by the customer such as SOQ.
  - Transco could discriminate in the way in which it calculates these values, Is Ofgem confident it can audit this process?
  - Since existing interruptibles have a baseline set to zero the comment under (1) are also relevant

- 4) Theoretical maximum physical capacity
  - These values are based on the maximum possible throughput of each offtake point, independent of the wider network. We therefore assume they are limited by the AGI or metering configuration. If this is the case is it possible for the DN or other offtake to change this without the agreement of Transco and if it did would this linkage with the baseline value be reflected in future price controls?
  - We would expect current interruptibles to have values at least as large as under option (2) and do not understand why this is not the case. (This issue has already been raised with Ofgem).
  - Signals for incremental capacity would only result in incentive revenues when demand exceeded these values, as such the incentive scheme might be largely irrelevant for a number of years.
  - This approach would require the largest buyback fund of all.
  - Clarity needed on how investment will be funded to deliver these baseline levels if required by shippers / DNs etc as this will not be covered by the incentives.

Proposed treatment of substitution and investment

We have serious concerns over the concept of substitution.

Ofgem considers that there is greater scope for substitution between offtake points than entry points and has used this to establish different incentives for incremental capacity provided investment or substitution. We consider the scope for substitution is a question of perspective. Clearly Ofgem's view is that of a network operator and we agree that from this perspective it is not possible to substitute entry capacity at St Fergus with that from Bacton, but it may be possible to substitute exit capacity of a power station with an adjacent DN offtake. However taking a customer perspective there is no possible substitution of exit capacity between offtakes as the capacity is defined as unique to each offtake, such that if a direct connect fails to secure capacity at its offtake in the long term allocation process for whatever reason then its baseline could be reduced and it will be unable to offtake gas. Whereas a customer considers there is full substitution at entry as it is indifferent as to whether the gas enters the system at St Fergus or Bacton.

Ofgem expects efficiency gains to arise from a number of areas, and we would agree that efficiency gains should in general deliver benefits to customers. However if in seeking these gains customers' interests are not protected then these must be brought into question. We consider that forcing customers into long term contracts with shippers for capacity purposes will have a detrimental impact on competition in gas supply, given that capacity is an integral part of gas supply. The issue is whether NTS connectees should face such strong incentives to book capacity in the long term and whether the risk of getting this wrong, an inability to flow gas or face overruns, is reasonable when their business may be placed in jeopardy. . Our view is that shippers will perceive that there is greater risk in supplying NTS connectees (both capacity and flow flexibility risk) and will build a premium into the price to address this, having a direct and detrimental impact on the customers concerned.

The concept of substitution was introduced into the business rules at a relatively late stage and there is no detail as to how this would work. This has been the subject of little discussion at Exit Reform Meetings as Transco considered this to be a licence issue.
In this respect we have a number of questions:

- What will the rules be that determine when and how substitution can take place?
- Will substitution be subject to pre-published exchange rates? We consider it should be
- How will we know that Transco is not discriminating when it substitutes capacity from one offtake to another?
- Who will audit the process?
- Where / when will revised baselines be published or made available to the affected parties?
- If substitution occurs in year 3 will this affect the baseline for future years
- Will substitution only be decided for year 3, with the decision being made for year 4 a year later once it becomes year 3? This would be consistent with the proposal to allow the auction revenue to be retained for one year.

We consider that the concept of substitution should only be included, if the rule concerning trading into a location being limited to the baseline level is relaxed and unconstrained interruptible capacity is made available on a dayahead and within day basis. Alternatively it may be more efficient to set exchange rates based on system capability and allow the market to trade in both the short and long term.

Whilst we do not agree with the concept of Transco substitution, if this concept is taken forward it may be logical to apply different incentive regimes to capacity provided by investment and by substitution. However we are unclear as to how long term buybacks fit into this incentive structure and the timing of the long-term allocation and buyback processes. Sites would be unable to offer long-term capacity to Transco until it had received its initial allocation, as it could not sell something it was unsure that it would receive. Similarly Transco may be unable to confirm firm capacity allocations until it had tendered for an assessed buy back offers.

Setting of UCAs for NTS offtake points

In the absence of any further information this approach would seem to be appropriate. However we are aware from PC76 that the setting of UCAs for each offtake point and their use in defining reserve prices could give rise to some significant changes to the exit capacity charges that are payable and may be dependent on the magnitude of the capacity increment that is used. We expect that that the setting of UCAs will be by a transparent process and we will provide comments when further information becomes available.

Treatment of maintenance costs

The Association does not yet have a firm view on this. We consider that the current co-ordinated approach to maintenance when it affects the ability to offtake gas works well and we assume that option three would include co-operation with direct connects as well as distribution network operators. However we recognise there may be benefits in establishing incentives in this area, but the most appropriate approach could be influenced by the buyback cost targets set. We also note that at exit Transco could be a distressed buyer of capacity as there would only be one party from which it could purchase it at most offtake points.

DN incentive schemes

The Association is uncertain of the flexibility that a DN has in booking NTS exit capacity given the requirements of its safety case which may be prescriptive in this regard. It would not be appropriate to place incentives on DNs if they are overly restricted in the way in which they can respond to them.

If DNs are free to respond to any incentives then the Association broadly agrees with the proposals for the DN incentive scheme with respect to the scope, form and duration, with the potential for a reopener as above. We consider fixed cost performance targets will provide the sharpest incentives to trade off DN investment and NTS exit capacity and flow flexibility bookings. We also agree that setting the caps and collars as a percentage of the cost performance target is appropriate given the locational variation in NTS exit capacity charges. We note that this gives rise to very small values for the DNs in Scotland and north of England, and that this might warrant further thought in case inefficiencies could arise.