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Dear Sonia

Initial thoughts on enduring incentive schemes supporting the offtake arrangements

Thank you for providing us with the opportunity to comment on Ofgem's initial thoughts on enduring incentive schemes to support the offtake arrangments following the DN sales.

EDF Energy continues to believe that no fundamental Exit reform is warranted in order for the Distribution Network (DN) Sale to proceed and are disappointed that Ofgem has persisted in radical reform of offtake arrangments against the majority view of the industry. The argument for uniform arrangements between DNs and Direct Connects (DCs) connected to the NTS has not been made and we believe the proposals put forward so far can be considered equally discriminatory against DCs, as stated in our response to Ofgem's Final RIA[1] and Transco's "Towards a new industry structure" consultation.[2]

We are also disappointed that Transco has chosen to pre-empt the proper development of the enduring offtake arrangements by including legal drafting for Exit flexibility charges[3] in the latest drafting of the Uniform Network Code (UNC). Ofgem's Decisions document made it clear that the enduring arrangements were not warranted prior to hive down as they were to be developed and implemented by September 2005 under a best endeavours obligation placed in the Gas Transporter's (GT) licences.[4] We believe that this

[1] EDF Energy response to Ofgem's Final Impact Assessment 16th December 2004
[2] EDF Energy Response "Towards a new industry structure, 24th January 2005
[3] Section B of the latest UNC legal drafting dated 17th February 2005
[4] Ofgem's conclusions document, Transco plc applications to dispose of four gas distribution networks, February 2005

has restricted and potentially compromised the development of suitable enduring offtake arrangements designed to address Ofgem's concerns as, for example, no alternatives to Transco's proposals have been put forward as yet.

We recognise that Transco may need some sort of arrangments to deal with liabilities at the NTS / DN interface but the introduction of an inadequately developed flow flexibility regime is neither efficient nor effective regulation. We ask that Transco removes condition 6 "NTS Offtake capacity" of section B of the UNC altogether until such time as the final Exit regime and enduring arrangements are properly reviewed and implemented and be replaced with something less prescriptive in the interim period to address the issue of quantifying exit capacity and flow flexibility. We have set out in the attachment to this letter some alternatives to Transco's only proposal for dealing with Ofgem's concerns under a divested industry.

Therefore, the comments we have provided are provisional, based on what has so far been proposed by Transco which may be different from the enduring exit arrangments implemented between now and September 2005.

We generally agree with the proposed incentive structures for exit capacity but note that Ofgem's consultation does not consider the baselines for flow flexibility for each exit point, even though it is already in the GT licence. We have therefore chosen not to comment in any great detail on flow flexibility at this stage.

However, we believe that these new arrangements are unnecessarily complex in nature and may lead to Transco receiving incorrect investment signals, extra industry costs and higher prices to end customers if not set correctly. In the light of Ofgem's statutory duty to protect the interests of consumers, we question the need for radical reform of offtake arrangments at a time when market volatility and prices are running at an all time high.

If you would like to discuss any of our comments further please contact John Costa on 020 7752 2522, or myself.

Yours sincerely

Denis Linford
Director of Regulation

Attachment

Further comments by EDF Energy on Ofgem's' Initial thoughts on enduring incentive schemes supporting the offtake arrangements

Definition of baselines

We have assessed the baseline figures in Appendix 1 and are comfortable these levels cover in most cases the maximum amount of physical offtake at those supply points. However, we believe that it is difficult to comment on the appropriate merits of either definition as it ultimately depends on the interaction between the product price levels, costs to customers and structure of the buyback incentive schemes. For example, option 4, "maximum physical capacity" of each NTS exit point, similar to how the Entry capacity baselines are set and will attract large support across the industry but it will naturally attract a larger buyback incentive from Transco to manage this level of capacity release which may not be utilised on the day and therefore lead to an unnecessary and complex redistribution of costs across the industry. We believe that a balance needs to be struck between the optimum amount of exit capacity release, the level of buy back funds and the right incentives structure so that capacity costs do not increase unduly and are properly targeted across the industry.

However, we generally concur that a definition of capacity release needs to be similar to that at Entry based on the maximum amount of Exit capacity that can potentially be made available through the efficient and economic operation of the system. This will incentivise Transco to ensure that the maximum amount of capacity is released to the market whilst guaranteeing that the cost per unit of capacity is minimised to realistic long-run marginal cost (LRMC) levels in line with customer's expectations.

We concur with the concept of substitution of capacity between sites and agree that failure to optimise in this manner could lead to inefficient investments being made. However, we are unsure whether Ofgem are proposing that baselines between sites would change permanently if a user did not use up all the capacity at one site if it was transferred to another. This would incentivise users to bid for maximum amount of capacity up front even though it was not needed to ensure it was made available at a later date which would not be economical or provide Transco with the right investment signals. We would suggest that, in order to achieve more realistic outcomes in the auctions, baselines should be kept constant from year to year, and only increase as per network configuration changes from year to year. For example, if Transco can prove that it can optimise flows across the network better from one year to the next through diversification of flows then this should be reflected in baselines quantities for the forthcoming year and highlighted through their 7 year planning process.

It is still not clear though how substitution of capacity will take place between offtakes in the short term through trading. Transco has not made it clear in their business rules whether Trading will be facilitated between sites in the three years after each auction or whether it will only be allowed nearer the day of delivery. We believe these rules need to be properly defined so that Shippers and customers understand the risks involved in participating in these auctions. Failing this, parties will be incentivised to secure as much capacity as possible at the auction stage rather than leaving it to real-time purchases which may send out spurious investment signals. Also, Transco introduced the concept of exchange rates between sites to facilitate trading but no further information on this proposal has been made available to date. We believe that trading via exchange rates is a complex and non-transparent way of exchanging capacity rights but believe if it is to be introduced then rates should be published 3 years out with trading enabled 3 years out.

In relation to interruptible capacity, EDF Energy are unsure how this will be made available in the short term and whether Shippers will have a choice to be interrupted rather than commit to allocated capacity in the unconstrained period. Ofgem has indicated that it will not be a "Universal Firm" regime come 2008 but yet no explanation of how interruptible sites can chose to be interrupted on the day has been put forward.

We believe that there should be an interruptible option to optimise use of the NTS capacity for users with back-up fuel who wish to take on the risk of Transco interruption. This would also minimise the strain on the system at peak times whilst providing Transco with a clear signal of the level of interruption in the market at any given time.

We would also like some clarity on how a use-it-or-lose-it mechanism will be introduced and whether it will follow the same methodology as for entry interruptible capacity. We are particularly concerned how storage sites will be treated under this new regime and whether they will have the option to remain interruptible as present. We believe that the cost of storage may increase unnecessarily if users are forced to procure daily quantities 3 years ahead on an annual basis when there is uncertainty of exactly how much and when in the year they might use it. Ofgem needs to give careful consideration to this point to ensure that the cost of Exit capacity do not artificially increase as this will potentially lead to an increase in gas prices which will ultimately be passed onto consumers.

Unit Cost Allowances (UCAs)

We believe the UCAs should be set at each offtake point to determine levels of investment but that these should be calculated on a 10-year basis similar to Entry points.

Product duration

EDF Energy believes that Exit capacity needs to be made available in sub-annual strips as well as annual in order for the auctions to be effective and efficient and so that Transco receives the proper investment signals. For example, Transco may get signals for annual strips when some parties will only need great seasonal strips for summer and some for winter capacity, yet combined together it will appear that over all participants will require double the amount of capacity as it is aggregated. Whereas, if it was split out, Transco would get a balanced picture of exactly where and when users needed Exit capacity reducing the potential for stranded capacity and conflicting investment signals.

We understand Transco's argument that the NTS is built around a peak day demand but we feel that under an annual strip only scenario shippers could bid for more capacity and potentially create signals for extra capacity when it is not needed in practice. Also, prices will tend to be over inflated in this scenario which cannot be considered an efficient way of allocating capacity as demand would be over stated for certain parts of the year. We believe that monthly or seasonal strips would be more economic and efficient and ask that Ofgem and Transco reconsider the types of product strips available.

It is not clear from the document what product strips will be available for short-term trading once we get into 2008 and whether shippers will be able to buy or sell capacity on a monthly or daily product. Clarity in this area would be welcome so that shippers can manage their capacity purchases ahead of summer if the auctions are to go ahead.

Enduring incentives schemes

EDF Energy generally agrees with Ofgem's proposals for NTS sharing factors of 50% and 100% for DN Operators (DNOs) to ensure that DNs do not over book capacity and use the swing inherent in their own networks rather than rely on the NTS for flow flex.

Enduring offtake proposals

We believe that little thought has been given to alternative offtake arrangements which could be designed to be less prescriptive and centralised whilst minimising the cost to shippers and consumers, especially where flow flexibility arrangements are concerned. We suggest one alternative is to only set a charge for requiring flow flex where Transco identifies a requirement for system balancing actions on the day as this would send out the proper signals for requiring flow flex. Shippers incurring charges on days where no physical system problems occur is neither efficient nor economic. Ofgem implemented the Incentivised Nomination Scheme (INS) modification 479 which was similar in nature and we welcome Ofgem's view on how they intend to present the industry with a chance to discuss and develop alternative proposals rather than just going with the first and only proposal raised.

EDF Energy
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