NGT- Potential sale of gas distribution network businesses.

Initial thoughts on enduring incentive schemes supporting the offtake arrangements
February 2005

Response by E.ON UK
10 March 2005

E.ON UK do not support the proposed enduring offtake arrangements, therefore we cannot support offtake incentive schemes designed to support such arrangements. Like most industry participants and customers who have expressed a view, we do not consider such changes to be necessary to facilitate the sale of gas distribution networks. Our preference is to base any enduring incentives on the more 'administered' approaches that currently apply to Transco, avoiding the need to link incentives to these risky experimental 'market based' allocation, exchange and buy-back mechanisms which we trust will not ultimately be implemented.

In the medium term we consider that if Transco were to rely on the proposed exit capacity/flexibility auctions for investment signals, overall investment in NTS system capacity could be unduly restricted or carried out in the 'wrong place'. NTS direct connects will either be unwilling or unable to give reliable signals to Transco through the long-term auction processes. Over time within-day flexibility may become scarcer as Transco is incentivised to operate the NTS 'flatter', with less variation of within-day flows. These operational constraints could also be exacerbated through likely significant further investment in gas fired generation capacity and new patterns and greater diversity of supply, e.g. LNG imports in the south placing greater operational demands on this system.

The NTS is the backbone for transporting energy supplies for the UK. We question whether it is wise to implement a highly experimental regime that may ultimately act against in developing the 'right' system both in terms of capacity and a higher overall degree of flexibility. Given the increasing strategic importance of the NTS, in "transporting Britain's energy" (Transco's phrase) we do not believe the time is right to rely on unproven market based approaches to 'signal' investment. In this environment, we also consider that it is not desirable to (in theory) design arrangements to encourage Transco to seek to always operate/make investment decisions at the efficiency frontier. It is better to incentivise the building of some spare capacity to create a more flexible system that is capable of meeting the changing needs of its users whether these are producers delivering gas or NTS customers or DNOs offtaking gas.

The current long-term planning process based on designing the system to meet the 1 in 20 obligation, although not perfect, has served the gas industry well. Enduring NTS incentives, in our view, should continue to be designed around this customer focused approach to developing the system.

Unfortunately, Ofgem's continued insistence on radical reform to the offake regime as pre-condition, of the sale process has in our view unnecessarily limited consideration of these more conventional administered approaches to NTS offtake incentive arrangements. We believe it is inappropriate for Ofgem to introduce conditional licence conditions requiring Transco and buyers to use best endeavours to bring forward enduring offtake proposals by 1 September 2005. We consider that such conditions prejudge or interfere with industry modification procedures and any recommendations that will made as part of such processes. Even if we agreed with the proposed enduring offtake regime, we do not believe it is practical to introduce these arrangements before 1 September 2006, without placing unnecessary risks on transporters and shippers.

Given the above concerns we would once again ask Ofgem 'de-link' the enduring offtake arrangements from the DN sales process, by withdrawing the proposed best endeavours conditional licence conditions. This will remove some pressure from Ofgem as there would no longer be an immediate requirement to introduce enduring incentives and the complex licencing arrangements that associated with such incentives. If the offtake arrangements introduced on day 1 of the UNC prove unsatisfactory, market participants will be free to propose changes as they see fit. Such a process would allow a more robust proposal to be developed to a more relaxed timetable, without particular parties feeling obliged to offer their support for a particular approach.

Given the vast array of documents associated with the DN sales process that the industry is having to review at the current time to very deadlines we are unable to spend time responding to detailed questions posed by Ofgem in this consultation. However, we have attached an extract of our response to Transco's 'Towards a new Industry framework' document, which outlines some of our more detailed initial thoughts on the proposed offtake regime, capacity management tools and incentive arrangements.

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Appendix A – Extract from:
Towards a new industry framework, a consultation by Transco, December 2004
Response by E.ON UK, 24 January 2005.

Appendix A – Extract from:

Towards a new industry framework
A consultation by Transco
December 2004

Response by E.ON UK
24 January 2005

Section I : Entry requirements

The proposed exit regime changes may indirectly impact on entry arrangement. For instance in reality it not possible to separate physical entry capacity provision from physical exit capacity on the NTS – such investment is inextricably linked. Although Transco will technically only make 'financially' firm capacity available their decisions whether to actually reinforce the system are linked to demands for access rights at both entry and entry. Is there anything required to link the auction processes together, e.g. resulting from changes to incentive arrangements, or perhaps more logically the need to develop an overall incentive regime combining both entry and exit?

Section J: Exit Requirements

It has been agreed that all commercial offtake terms between the NTS and DNs should be included in the UNC and be subject to the UNC Modification Rules. We understand so called technical and day to day operational matters will be covered in bilateral arrangements between Transco and DNOs. The demarcation between commercial and technical matters is always difficult, and there is always a risk that any new commercial terms that may need to emerge over time might inappropriately be included in these bilateral documents. An appropriate safeguard would be to require the scope of technical issues to be specified as "Network Exit Provisions" in the UNC. This would be consistent with the Network Exit Agreement arrangement that already exist for NTS direct connects. Parameters such as pressure commitments may be different at different locations on the NTS but are nevertheless critical to any commercial definition of exit capacity. The approach whereby the technical and operation scope of <u>all</u> bilateral "offtake arrangements" are specified in the UNC will help prevent undue discrimination between NTS connects and furthermore will not prevent shippers from proposing changes to the form of such arrangements as is open to them under the existing Network Code.

NTS exit regime

E.ON UK remain firmly of the view that radical exit reform is not necessary for the DN sale to proceed. Our preference is for the administered arrangements (Option 1 of the Offtake regulatory impact assessment) to apply. It is our view any discrimination concerns in the treatment of different classes of NTS connectees can satisfactorily be dealt with through information transparency, robust internal separation arrangements and normal regulatory oversight of monopoly network businesses.

Given our opposition to these proposals our comments on the proposed exit regime should not in any way be seen to lend any legitimacy to Transco's proposals. Transco should not therefore quote our views before first noting our opposition to these proposals.

It is also impossible for E.ON UK at this stage to give full and considered comments on the exit proposals, as we haven't yet seen the 'complete picture'. Without information on incentives and in particular the baseline capacity and flexibility, reserve prices, exchange rates and knowledge of the interactions between entry and exit baseline obligations assessment is difficult. We can only reply to Transco's conceptual thinking with a conceptual response. If flexibility were to remain cheap and plentiful over the long term, we could probably learn to live with the proposals, but if primary capacity rights are taken from 'under our feet' and flexibility becomes progressively more scarce and expensive, and this undermines our ability to generate electricity when and where we want to, the proposals would be very worrying. Even ignoring the obvious benefit for Transco of ensuring regulatory approval for the DN sales to go-ahead, Transco have certainly more to gain from these proposals than shippers, and their NTS customers.

The benefits to Transco perhaps include obtaining another lucrative capacity incentive scheme with the ability to play one incentive scheme against another; more indirect tools for them to 'interfere' in the gas and electricity wholesale markets (a further shift away from their residual role in the market), and possibly improved signals for investment? Transco's view on the later in their latest statement is however,

"….in relation to existing entry points, the auctions are still to provide us with clear signals that would justify investment above the baseline adopted for our present price control period."

Balancing this would be the risk of buy-back exposure for failure to make available capacity, which in extreme situations would most likely be 'capped-off' by regulatory intervention.

A conceivable benefit for shippers/end customers might include the ability to fix capacity and flexibility prices for between [8] and [15] years (if agreement for such a commitment were feasible and very unlikely for NTS customers other than generators). This must be weighed against a shift to 'financially firm' products with a risk that regulatory intervention prevents fair compensation via the buy back mechanisms. Compared to the current regime whereby exit capacity is a 'bundled' product that will continue to be made available if rebooked from year to year these proposals are not exact an attractive proposition for shippers and customers.

Exit Capacity product

Length of period for long–term capacity offer

In theory shippers should have the opportunity to purchase exit capacity for up to 15 years. However, the value of a 'financially firm' product is highly dubious without firm pressure commitments. A 'guarantee' on pressure is in effect a 'physical' exit capacity commitment by Transco, which might be worth purchasing for more than one year ahead. There is also the risk of regulatory intervention that could enhance/reduce the utility of any long term capacity product purchased. This almost inevitably tends to make parties more short-term focused say no more than 5 years out. The other major risk is, will the arrival of new entry points particularly LNG importation facilities in the south, change the whole configuration and operation of the NTS? This may force a major rethink of both the entry and exit capacity long-term auction arrangements.

We remain sceptical that many NTS direct connects will in reality able to plan their business activities so far into the future to be able to enter into arrangements with shippers to procure long term capacity. Generators may be in a slightly better position to make these commitments, but electricity market conditions may be such that at the margin mothballing/de-mothballing decisions could be affected.

Annual bundles day-ahead and within-day offerings

We agree with Transco that firm capacity should be made available in annual bundles, day-ahead and within-day. It is imperative that a facility is available for acquiring access rights within-day, given that there are a number of occasional offtakers from the NTS who require back-up gas supplies at short-notice. We recognise that firm capacity may not always be physically available on the day, but to the extent that it is, users should have the opportunity to acquire that capacity at the day ahead stage (as insurance it will be available the next day) or failing that at the last minute within-day.

Should exit users be free to demand capacity at any location?

(Please note the concepts described in this section could also apply to the purchase of flexibility).

Given the use it or lose it arrangements and provided Transco are obliged to offer all spare capacity that is available to the market, there is no particular reason why this should be explicitly be excluded in the rules. However, in most cases it is difficult to see why users would want to acquire capacity at a point on the NTS where it had no intention or right to offtake gas. It might however be a means for shippers/DNOs to acquire capacity for an internal transfer of capacity from a node they are not active at to secure additional capacity at a node where they are. This would in effect be a market mechanism whereby users could according to their immediate need to offtake gas (e.g. driven by electricity 'spot' prices) directly influence the availability of capacity at neighbouring offtakes. This would ensure 'the market' is influencing local NTS operational choices, rather having to go through Transco who will be optimising at what points capacity is made available on the day.

Should the certification process continue at interconnectors?

Probably, but for the reasons above, if there is merit in users at offtakes at which they are not taking gas acquiring capacity, perhaps alignment of firm capacity rights with downstream rights in the interconnector is not strictly necessary.

It is probably useful to distinguish between rights to offtake gas from the NTS from the rights to deliver gas into another operator's system. Actual rights to physically flow gas are in reality always determined by the downstream network operator.

Should facilitated trading take place beyond 1 year?

Yes. Access to capacity in the constrained medium term period could be limited and therefore, acquisition through facilitated trading may be the preferred vehicle for obtaining capacity from the market. This may be preferable to waiting for Transco to make available 'spare' capacity on a short-term basis. It is therefore logical to have facilitated trading for 3 years out. There is also no reason at all why it cannot be for longer periods. In any event the exit capacity systems should allow users to transfer capacity at a node or between nodes (at given exchange rates) within a shippers portfolio. Whether this has to involve Transco as an intermediary, we don't know. Is that what is meant by facilitated trading? Does facilitated trading merely mean bringing sellers and buyers together or does Transco take a position in the middle?

Having said that we are very sceptical that much facilitated trading of exit capacity will go on, if the level of trading of entry capacity is anything to go by.

Use it or lose it or unconstrained interruptible capacity?

The key point here is that Transco should on the day be required to make available all physical capacity to the market. No capacity should be held back from the market. In this context we don't really understand the distinction being made between UIOLI or unconstrained interruptible capacity. From the shipper point of view the only distinction is the 'flakiness' of the product. The 'flakiness' of the product depends on the prospect of an interruptible user being 'bounced' by the firm capacity holders and the amount of interruptible capacity sold. Unconstrained implies the potential for interruptible 'capacity' to be 'oversold' and all that means is that users will simply bid up the volume of interruptible capacity they require to secure the amount they need. This is instead of biding a higher price for a UIOLI product which is 'constrained' to the amount of physical capacity Transco believes it has a reasonable chance of making available.

Should the release of products be made available within day?

This is essential anti hording mechanism. Please also see our comments on back-up supplies to the question on product periods above.

First auctions in September 2005 and thereafter in April?

We are open minded about when the auctions should take place, but see merit in an April date because this may help with the planning cycle and facilitates earlier network reinforcement. We think that consideration of alignment of entry and exit capacity auctions is probably necessary given that actual decision to reinforce the NTS is influenced by both the pattern of future deliveries and offtakes from the system (but this of course depends on what value Transco places on the signals it receives from the auctions). Nevertheless, we haven't had the opportunity yet to discuss our internal administrative constraints of scheduling entry and exit auctions at similar times of the year.

One thing is certain the definition of the annual periods should remain aligned to the gas year and not set April to March for the convenience of Transco's formula year. This is to enable us to align these arrangement and any changes to NTS transportation charges result from exit capacity auction over or under-recovery to the annual contracting rounds with customers.

6 year pressure commitments for NTS direct connects?

Pressure commitments are the closest thing users have to real physical capacity. It is this that gives us confidence that the gas will flow when we want it to. We therefore welcome the commitment to a 6 year pressure commitment for NTS direct provided Transco drafts such a commitment in a similar form (apart from the number) to the 3 year commitment already given in Network Exit agreements.

Please also refer to our comments on pressure commitments under "Length of period for long–term capacity offer" above.

Flow flexibility

Transco state that,

"The NTS will …. have a Capacity Management tool specifically designed to enable it to better manage operational uncertainties created by a wide and/or unexpected flow rate variations."

We do not believe this flexibility product will achieve the claimed benefit as all it does is to incentivise uses to offtake at lower rates before 22.00 hrs compared to rates after that time relative to what might otherwise been the case without the flex incentive.

Real provision of flow flexibility is in reality an operational concept in which Transco manages flows and pressure on the network to accommodate the changing requirements of users. Transco already does this effectively through advance notice of flows (offtake profile notices (OPNs)) and rate change notice periods from shippers. The proposed flow flexibility does not in our view provide additional added certainty for Transco. If Transco were really to believe in this service they would be happy to remove all the flow restrictions currently set out in Network Exit Agreements.

Transco also states that;

"Flexibility on the NTS has to date been generated as a by-product of designing the NTS to meet the peak aggregate daily demand for gas assuming a constant rate of offtake."

We would suggest flexibility will almost certainly remain a by product. Under particular feasible scenarios for the likely configuration of the NTS in 10 years time the amount of this flexibility by-product may increase significantly. This is because with more entry points and greater uncertainty over the likely flows at future southern LNG importation facilities (market price could mean LNG tankers diverted to America), the system is likely to have to be designed with more overall flex. It would no longer be safe to assume that gas will always be delivered from particular terminals or combinations of terminals at particular times of the year.

Should flow flexibility be offered for [8] or [15] years

In theory up to 15 years should be permitted but given the regulatory and market uncertainties described above, would purchasing such long term flexibility be wise. It would seem that DNO are in a better position to make such commitments compared to other than other NTS connectees.

Should volume be the only dimension that is monitored for the purposes of overruns?

We do not support hourly overruns, as this potentially places too many constraints on NTS customers' operations. The flexibility product as currently defined using 'volume overruns' may be an irritation for generators in the short-term, but hourly overruns overlaid on NExA rate change notice periods, ramp rates and penal daily overruns could become a major headache. It will almost certainly introduce rigidities into the gas market that may restrict the ability of generators to respond effectively in the electricity wholesale market.

Should facilitated trading take place beyond 1 year?

Yes, see our comments to a similar question on exit capacity above.

Should the release of products be made available within day?

This is a question we have added. Why not would be our response if we had been asked this question. If it is possible to buy exit capacity within-day why shouldn't be possible to buy flexibility capacity within day. After we already have a "ticket to ride" principle where tickets can be bought on the train i.e. part way through the journey (within-day).

First auctions in September 2005 and thereafter in April?

Yes, see our comments on a similar question on exit capacity above

NTS capacity management

The range of tools that are proposed for Capacity Management purposes

Unfortunately with the reform of gas trading arrangements (RGTA) came the idea of separating energy and capacity regimes and with this package came the inevitable array of capacity management tools which were designed to indirectly affect the flows into and out of the system. The simpler direct system sell energy actions prior to 1999 were nevertheless always effective, although sometimes costly in managing constraints.

It seems inevitable that with the arrival of exit capacity auctions comes the similar NTS exit capacity management tools. In this regard locational OCM purchases are the best most and most straight-forward and transparent way of managing locational constraints and we would prefer this simple effective tool to remain the key tool for Transco to manage energy capacity constraints. Every new capacity tool represents another potential means for Transco to intentionally or not interfere in the market, and this in turn can undermine the ability of that market to respond appropriately to the pricing singles which may not be immediately visible to the market. In this regard we are most concerned about allowing Transco to enter into longer-term bilateral capacity deals with shippers.

In short we say NO to exit capacity and flexibility auctions and NO to the Exit Capacity tools that come with it!

If these arrangements are still to be forces upon us, it would be useful if Transco could at least develop software tools so that users can at least be able to acquire the right levels of capacity and flexibility. We were thinking in particular of software to 'automatically; calculate within-day capacity and flexibility requirements bearing in mind a given PPN profile at a given point in the day. This could form part of the buy-back and facilitated trading processes.

Scale back rules in the event of market failure

These rules may be applicable in the case of genuine market failure. Unfortunately when Transco has sought to define such circumstances in the past in Operational and Procurement

Guidelines Transco has given itself so many get out clauses as to give us little confidence that they will take all relevant buy back offers if they are available irrespective of the price. It is never Transco's role to suggest whether an offer price is favourable or not favourable. The onus is on the seller to ensure prices offered are consistent with Competition Law.

We would only accept this concept if there is a firm and 'watertight' obligation on Transco in the UNC to exhaust all available market actions prior to scale backs.

Incentives, baseline and pricing

Transco usefully sets out the issues in this section although detailed proposals have yet to be brought forward. The following comments reflect these uncertainties, but hopefully will assist in making the 'right' policy choices going forward.

E.ON UK remains rather sceptical about the value of NTS capacity incentive regimes. We would prefer to rely solely on Transco's current 1 in 20 obligations to ensure Transco invests appropriately in system capacity. The current 1 in 20 firm quantities in Transco's licence enable Ofgem to monitor Transco performance in meeting such a target. Whether yet another complex incentive scheme would realise real benefits for customers – we very much doubt it.

Our initial view is that if there were to be an incentive scheme baseline capacities should relate to this existing 1 in 20 firm measure. Some of the other measure may overstate the baseline capacity and might lead Transco to 'over-invest'. As regards flexibility measures the proposals seem discriminatory e.g. for one of the options the DNs seem to proportionately allocated more baseline flexibility than NTS direct connects. It would seem that allocations should be on a firm only basis if one assumes that capacity constraints will take interruptible users off the system before flexibility constraints kick in (flexibility being a by product of investment in physical capacity after all).

Charging arrangements

The likely changes to charging arrangements that result from the change to the exit regime are likely to replicate all the worst aspects of the entry capacity auctions. Unnecessary complexity, new charging elements, significant within-year price changes are all likely to emerge as unwanted side effects of this new regime. Again this will create costs and uncertainties for shippers, and the added price volatility will felt by customers either in pass through arrangements with large consumers or changes to domestic user tariffs.

We shall comment in detail on the new charging arrangements when these are published.

Implementation dates

The implementation dates are totally unrealistic. In our view it would be better to delay the first long-term exit capacity auction (2009/10 onwards) to summer 2006. The indecent haste with which these proposals are being brought forward, almost inevitably means parties are unable to adequately scrutinise, comment and properly refine the proposals. The chances of robust proposal being delivered that take into account the needs of users (i.e. shippers and their customers as well as DNOs) by summer 2005 seem very slim indeed.

Interim Arrangements

We do not consider the gate closure concept to be workable in practice. In reality it is not possible to hold off all users increasing their take of gas until a “gate-closure” decision point. We understand from Transco that they have only ever refused requests for flow flexibility on 2 or 3 occasions in the last 3 years so competition for flexibility in a particular locality seems highly improbable.

This illustrates why the current arrangements whereby Transco allows users to exceed NExA rate change notice periods with prior permission work well. There are a number of locations in which users need immediate permission from Transco to take back-up supplies from the NTS. Strict adherence to this “gate-closure” rule would force would force CCGTs to interrupt generating.