RWE npower

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

Your ref
Our ref
Name Charles Ruffell
Phone 01793 89 39 83
Fax 01793 89 29 81
E-Mail charles.ruffell@rwenpower.com

10th March 2005

NATIONAL GRID TRANSCO – POTENTIAL SALE OF GAS DISTRIBUTION NETWORK BUSINESSES
Initial thoughts on enduring incentive schemes supporting the offtake arrangements

Dear Sonia

We welcome the opportunity to comment upon the issues raised in this consultation.

General Comments

The requirement for the incentive schemes arises as a result of Ofgem's proposed structure for enduring offtake arrangements. These arrangements are designed to address concerns that the NTS will be able to unduly discriminate between NTS connectees in the allocation of NTS exit capacity and flexibility. We strongly believe that a planned approach remains appropriate until the extent of any actual or potential discrimination can be quantified. We remain to be convinced that such fundamental reforms are necessary in the context of DN sales. At this point, it is not clear why Ofgem does not feel confident that the GT licence, together with Competition law provide adequate protection in this area.

Under the proposed enduring offtake and incentive arrangements interruptible capacity will only be released as a day-ahead product. It is not yet clear whether existing interruptible customers will demand firm capacity and, depending on how baselines are set, whether this will result in additional NTS investment. We would argue that interruptible capacity should always be a feature of a network designed to meet peak transmission requirements, largely for weather sensitive loads. On this basis, there is a question over whether the investment is efficient if it leads to an over-sized and unconstrained system. It should be noted that the perception of "efficiency" would be different for the network owner than for the individual capacity owner at each node. Their requirement is for efficiently provided physical capacity to meet their operational

RWE npower

Trigonos
Windmill Hill
Business Park
Whitehill Way
Swindon
Wiltshire SN5 6PB

T +44(0)1793/89 39 83
F +44(0)1793/89 29 81
I www.rwenpower.com

Registered office:
RWE Npower plc

needs, as buy-back prices are unlikely to reflect fully the opportunity cost of not flowing gas. If forced to buy long-term firm capacity, there is a risk that interruptible users will de-commission back-up facilities and this may weaken security of supply.

Furthermore, it is unclear how the value of buy-back can be assessed in relation to the two different drivers on Transco: day to day efficient operation of the system by the SO; and long term efficient and economic investment in regulated transmission assets by the TO. In essence, interruption, storage and linepack may have a different value for the TO (avoidance or deferral of investment) when compared with the value for the SO (short-term constraint management). This gives rise to a potential conflict of interest between the SO and TO, as Transco may require the same contract for two different purposes: for short-term system operation (SO) or as an alternative to investment (TO). We would, therefore, welcome clarification of Ofgem's thinking on this matter and how it will be treated.

Specific Questions for Consultation

The proposed form, scope and duration of the NTS and DN enduring incentive schemes
We believe that there is a need for a stable, robust and enduring regime for the incentive scheme. Experience in the initial short-term entry capacity auctions, with complex rule changes implemented at the last minute demonstrated the potential problems. Our preference would be for incentive parameters to be established for the full duration of the scheme as this will increase certainty and reduce possible volatility in prices for both system users and end customers, although we accept the logic of a re-opener.

The appropriate methodology to be used in defining baselines for both NTS exit capacity, and NTS exit flow flexibility
The definition of the baseline leads onto concerns over buy-back liabilities and sharing of risks between Transco and shippers. In creating a fair and equitable market place, exposure to buy-back costs is a significant factor in determining demand for and value of long-term rights. If shippers remain exposed to smeared buy-back costs which are both uncertain and unknown they will inevitably discount prices paid or expose themselves to potentially unlimited risks. This will further dilute any signals emerging from long-term allocation mechanisms. We would like to understand the buy-back regime and the level of incentive payments more fully.

We have yet to see the proposal for flow flexibility and so are unable to comment.

Whether baselines should be defined as a constant, or whether these should increase over time
We can see some logic in building load growth assumptions into the DN offtake baselines, but not for the direct connects.

The indicative baseline numbers provided by Transco
As discussed above, there will be an interaction between the baseline, the buy-back arrangements and the level of target buy-back costs. Until we can assess this more fully, we cannot indicate our preference, although we endorse the comments made by the AEP on this issue.

The proposed treatment of substitution and investment as part of the enduring incentive schemes
We agree that it is appropriate to apply different incentive regimes to capacity provided by investment and that by substitution. Furthermore, there is a difference between buy-backs for short-term operational reasons and buy-backs as a long-term surrogate for investment in capacity, but it is not clear how Ofgem intends to distinguish between them. We believe that for

investment-related buy-backs, holders of firm rights should not be exposed to any smeared costs and that these costs should sit 100% with Transco. On this basis, Transco would be incentivised to ensure that buy-backs are at procured at the lowest cost available and that buy-backs are efficiently valued relative to other options available to Transco. Operational-related buy-backs are part of the cost of system operation and our preference would be to recover these independently of capacity holdings and through a use of system charge. Our strong preference is for a clean capacity product, free from buy-back liabilities.

The ability for the SO to substitute offtake rights between offtake points does add considerable complexity into the allocation process. It is unclear whether shippers will have a clear ex ante view of the exchange rates that Transco will use in its IExCR model to optimise capacity release or whether the myriad of exchange rates that will be needed will be subject to regulatory scrutiny. Substitution increases the uncertainty faced by users at each node as they run the risk of capacity at their node being substituted and not available in the short and medium term allocations. Exit capacity is effectively made into a homogenous product on the NTS because of substitution and therefore should be offered in an auction with zero reserve price.

The proposed approach to the setting of UCAs for NTS offtake points
In principle, it makes sense to utilise the methodology developed for entry capacity UCAs, although the detailed parameters underlying the calculation may need to be recalibrated given the differential in incremental loads between entry and exit.

The most appropriate way of ensuring consistency between the enduring DN incentive schemes and the DN price control review
As drafted, the proposals for the scope, form and duration of the DN incentive scheme should reduce the natural incentive to overbook NTS exit capacity and flow flexibility. We have not yet formed a view on the proposed level of the incentive targets.

Yours sincerely

Charles Ruffell
Economic Regulation