

## Commercial Interface Working Group Minutes

### Meeting 11

7 July 2004, 10:00 am – 2:00 pm

Ofgem's office, 9 Millbank

#### Attendees

Beverley Grubb	SSE	Mark Sutton	NGT
Adam Whitmore	Deloittes	Adam Davidson	NGT
Mark Feather	Ofgem (chair)	Nigel Sisman	NGT
Jason Mann	PA Consulting	Michael Young	British Gas Trading
Jess Hunt	Ofgem	Nick Wye	Waters Wye
David Ashbourne	Ofgem	Bob Bruce	Glenton Bruce
Richard Street	Statoil	Steve Rose	RWE Innogy
Julie Cox	AEP	James Smith	EDF Energy
Steve Ladle	Total	Tim Dewhurst	PA Consulting
Christiane Skyes	E.on UK		

#### 1. Review of items from previous CIWG meeting (held 16 June 2004)

##### a) Minutes

Nigel Sisman suggested a correction to the description of the discussion of inter-LDZ offtake points, which Ofgem agreed to make.

##### b) Actions

The following actions arose at the previous CIWG meeting:

- ◆ *Group to provide feedback to Ofgem regarding which issues they consider to be important. The AEP had asked Ofgem to answer a number of questions regarding the Offtake Arrangements RIA. Ofgem intended to respond to the key issues later in the meeting.*
- ◆ *Ofgem to prepare a detailed forward work plan setting out issues to be considered over the next four meetings, to be discussed at CIWG 11. Ofgem had circulated a table that sets the issues to be considered over the next four meetings.*
- ◆ *Ofgem to circulate issues log for discussion at the next CIWG. Ofgem had not circulated the issues log. The group agreed to postpone its review of the issues log until 28 July, as set out in the forward work plan.*
- ◆ *Group members to come prepared to consider the advantages and disadvantages of each of the issues raised in paragraph 5.9 of Ofgem's Roles and Responsibilities Decision Document at CIWG 11. SOMSAs were on the agenda to be discussed later in the meeting.*

- ◆ *Group members to critique Transco's notes on SOMSAs and identify what additional information is required. Ofgem had not received any further comments regarding SOMSAs and therefore assumed that no additional information is required.*

## **2. Update from the Development & Implementation Steering Committee**

Mark Feather told the group that the DISG had discussed:

- ◆ the constitution of the governance entity, including the extent to which the governance entity should have its own industry experts to assist in processing modification proposals;
- ◆ the governance of the agency including the allocation of board voting rights;
- ◆ the arrangements for responding to emergencies including an inter-operator agreement that provides for networks to support each other during emergencies; and
- ◆ the role of the SPA workgroup, and the resolution of ungoverned services currently provided by Transco to shippers, supply points and customers.

## **3. Forward work plan**

Ofgem had circulated a forward work plan which set out the issues to be considered at each of the next four CIWG meetings. Jess Hunt noted that at the DISG it had been suggested that the CIWG also consider the issue of shrinkage. Mark Feather said that Ofgem hoped to issue a more long term indicative timetable shortly.

## **4. Ofgem presentation on interruptions RIA**

Jason Mann gave a presentation describing the key features of Ofgem's interruption RIA, which was published on 30 June.

### *Unconstrained capacity*

The group discussed the meaning of unconstrained capacity. Jason Mann explained that under an unconstrained approach, shippers could apply for as much capacity as they want. The applications would be backed by firm financial commitments. Network operators would be obliged to provide this capacity, and if the amount of capacity requested exceeds the physical limits of the network, then network operators would need to either invest to meet demand or enter into interruptions contracts.

The group compared the unconstrained approach to the current method of allocating capacity, the 'first come first served' approach. Mark Feather noted that at present, capacity is booked on an annual basis, and consequently there is no opportunity for shippers to signal their long term requirements (which could trigger an investment). Julie Cox suggested that first come first served performs no worse than an unconstrained capacity allocation mechanism in terms of non-discrimination, however, the group generally agreed that new customers would need to wait longer to receive their allocation of capacity under first come first served than under an unconstrained approach.

### *Matrix approach*

Julie Cox asked whether the price offered by the network operator for interruption services under the matrix approach would reflect the network operator's costs. Mark

Feather said that the objective of the interruptions arrangements is to extract a market value for interruption so that Transco can efficiently trade off the costs of interruption against the costs of other constraint management tools such as network investment. Nick Wye noted that the GT licence condition requiring costs reflectivity relates to the firm capacity product and that interruption is not a capacity product.

#### *Contractual arrangements*

The group discussed the contractual framework for interruptions. Mark Feather explained that this issue was still open – both in terms of NTS contracting for interruption in respect of sites connected to the DNs, and in terms of whether network operators would enter into contracts with shippers or customers.

#### *Qualitative assessment*

Mark Feather said that Ofgem considered that Option 3 creates more efficient investment signals than the other options. This is because if capacity is constrained, shippers will have stronger incentives to make long term capacity bookings as there is a risk that otherwise they will miss out. Mike Young suggested that a constrained capacity allocation mechanism could potentially have a negative impact on retail competition because suppliers would be unwilling of taking on new customers if there was risk that capacity rights would be unavailable. He suggested that this issue would be especially relevant in the case of large I&C customers. It was noted that an anti-hoarding mechanism would be required under Option 3.

Bob Bruce asked why Ofgem's cost benefit analysis did not include an assessment of Options 3A, 3B and 3C and instead assesses Option 3 as a single option. Jason Mann explained that the differences between constrained and unconstrained firm capacity overwhelm the nuances between the different interruptions contracting mechanisms. Further, it was not necessary to repeat much of the discussion of the interruptions options that had occurred under the Option 2 unconstrained approach. He said that under Option 3, the interruptions arrangements are far less significant than under the other options because the firm product is more carefully tailored to network availability under Option 3. Julie Cox noted that interruptions would be a very different product under Option 3.

#### *Relationship between Offtake Arrangements RIA and Interruptions RIA*

The group discussed the relationship between the options for allocating NTS exit capacity set out in the Offtake Arrangements RIA and the options for interruption set out in the Interruptions RIA. Beverley Grubb and Julie Cox said that they believed the Offtake Arrangements RIA was written in a way that implies that Options 2 and 3 adopt an unconstrained approach to capacity allocation. Ofgem said that this was not the case, and noted that the document explains that the method of allocation of network capacity in the short term is an issue that needs to be determined for all options.<sup>1</sup> Jason Mann said that Options 2 and 3 could accommodate a constrained capacity allocation mechanism with respect to short term capacity allocation. Mark Feather noted that in the long term constrained and unconstrained approaches become similar.

Mark Feather said that as the two decisions are interlinked, the Authority would not make a decision on the Offtake Arrangements RIA until it had considered comments received in relation to the Interruptions RIA.

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<sup>1</sup> This issue is discussed on pages 39-41 of the Offtake Arrangements RIA.

Steve Ladle asked whether Ofgem had conducted a risk assessment of the various options. Mark Feather said that Ofgem had done this as a part of its qualitative and quantitative cost benefit analysis which included an assessment of security of supply issues.

## **5. Pros and cons of SOMSA issues raised in Roles & Responsibilities Decision Document**

The group considered the following questions, which are set out in paragraph 5.9 of the Role and Responsibilities Decision Document:

- ◆ Should Ofgem regulate the prices charged under the SOMSA arrangements and any associated liability clauses?
- ◆ Should the SOMSAs be published in order to enhance transparency?
- ◆ Should changes to the SOMSAs be subject to consultation?
- ◆ Should Ofgem have a veto over any proposals to change the SOMSAs?
- ◆ Should service standards be introduced with respect to the SOMSAs?

The group agreed that it would be important that the SOMSA arrangements are 'zero sum' with respect to shippers and customers. Mark Feather noted that since the allowed revenue for DNs by shippers are already determined under the current price control, customers and shippers would not be affected by the SOMSAs in the short term. He agreed that, going forward, it would be important to ensure that there is no opportunity for system operation costs to be recovered twice.

Adam Whitmore made a distinction between present price controls and thereafter, on grounds that by the next regulatory period IDNs will have had the opportunity to establish their own area control centres, however in the short term they have no choice but to rely on Transco. Some group members considered that this lack of choice was an argument in favour of short term regulation of SOMSAs.

Several members of the group suggested that since, in the long term, IDNs could choose to build their own area control rooms, regulation of SOMSAs should be a short term measure only. Jason Mann said that regulation of SOMSAs in the short term was unnecessary because potential buyers would have the opportunity to agree on the SOMSA arrangements as a part of their overall purchase negotiations. Consequently, if an IDN considered the SOMSA to be unfavourable, they could lower their offer accordingly.

Beverley Grubb suggested that a potential advantage of regulating the SOMSA is that it would increase transparency, thereby promoting efficient comparative regulation at the next price control. She suggested that a transparent approach would be to require IDNs to pay only the allowance set out in the DN price control for SOMSA services. She noted that if the SOMSAs were unregulated, Transco would be able to extract an unregulated revenue stream from the DNs' regulated revenue base. Mark Feather said that there would be a driver on DNs to push back hard on Transco when negotiating prices and liabilities under the SOMSAs.

After some discussion the group agreed that there was no need to regulate the SOMSAs as DNs would not be able to pass through SOMSA charges to customers under the existing price control. The group noted, however, that questions arise as to how Ofgem will determine the level of efficient expenditure associated with SOMSA services at the time of the next price control review.

The group discussed the liabilities that would arise under the SOMSA if a security of supply failure occurred, or if quality of service standards were breached. Ofgem stated that legal and regulatory responsibility lies with the DN. Adam Whitmore asked what liability provisions were in the SOMSA. Adam Davidson said that potential purchasers will need to make a choice on what they are negotiating for – a cheap product with limited Transco liability, or a more expensive product with higher Transco liability.

The group considered the remainder of the questions set out in paragraph 5.9 of the Role and Responsibilities Decision Document. It was agreed that each of these questions flow on from the initial question of whether SOMSAs should be regulated, and if it was decided that it was not necessary to regulate the SOMSAs, then the other questions should also be answered negatively.

**6. Transco paper on definition of boundaries between NTS/DN**

Discussion of this issue was postponed until 14 July 2004.

**7. Transco paper on connection facilities & telemetry**

Discussion of this issue was postponed until 14 July 2004.

**8. Transco paper on maintenance**

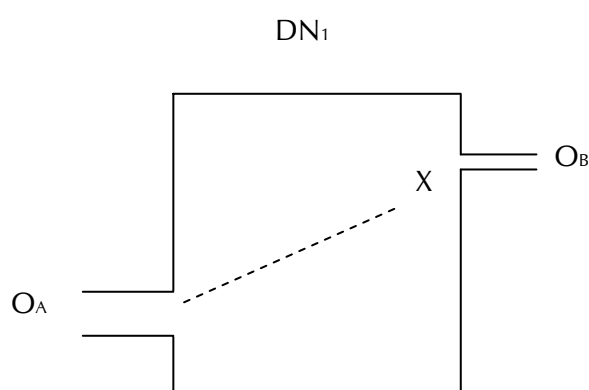
Discussion of this issue was postponed until 14 July 2004.

**Any other business – AEP questions on Offtake Arrangements RIA**

Tim Dewhurst gave a presentation responding to key issues raised by the AEP in feedback provided to Ofgem.

*Question 1. How is it possible to substitute NTS exit capacity for investment within the DN in respect of the MDQ under Option 2?*

Tim explained that as DNs and the NTS will be separate commercial entities, in the absence of efficient incentives, DNs may seek to pass investment costs onto the NTS when it would be more efficient for the DN to undertake the investment. Consequently, it is important to ensure that network operators have incentives that promote efficient investment decisions across the network as a whole.



For example, if DN<sub>1</sub> has to supply consumer X, and NTS offtake point O<sub>B</sub> is constrained, it might be cheaper for the DN to invest in a pipe to supply from (unconstrained) O<sub>A</sub>.

However, with no incentives, DN might prefer to request more NEC from O<sub>B</sub> rather than invest.

Some members of the group said that they had interpreted the Offtake Arrangements RIA to suggest that DN capacity could be substituted for NTS exit capacity (or MDQ), however in the example above the same amount of NEC is required and the

issue was whether it was purchased from O<sub>A</sub> or O<sub>B</sub>. Ofgem confirmed that it is the investment expenditure that can be substituted, rather than the overall quantity of NECs.

*Question 2. Will the 1 in 20 obligation be removed from the NTS under Option 2?*

Tim Dewhurst said that under options 2 and 3 the 1 in 20 obligation will be placed on DNs. He said that it is for further discussion whether this obligation should also be placed on the NTS. Julie Cox noted that the quantitative analysis in the Offtake Arrangements RIA assumes that the NTS incurs fewer investment planning costs under Option 2, which suggests that there is an assumption that the NTS does not have a 1 in 20 obligation.

*Question 3. Will DNs or shippers pay for the cost of “additional” NEC under Option 3?*

Tim Dewhurst said that the cost of additional NEC requested by the DN to ensure that NTS offtake points meet 1 in 20 would be charged back to shippers. Julie Cox noted that this approach would create an incentive for shippers to minimise the amount of NEC that they book. Mike Young said that prudent shippers would be forced to bear the costs of high risk strategies.

*Question 4. Does DN exit capacity need to equal NTS exit capacity under Option 3?*

Tim Dewhurst said that there is no reason why total requested DEC must equal requested NEC - for example, DEC requests may exceed NEC requests if diversity of consumers is reflected in capacity requests by shippers. Nigel Sisman noted that NEC requests could exceed DEC requests because the DN would need to take account of its 1 in 20 obligations when booking NEC.

*Question 5. How does competition arise for NTS and DN exit capacity given that the DN and NTS has to provide what is requested under Option 4?*

Ofgem said that under Option 4, shippers request the level of NEC and DEC they require. As a result, there is a positive incentive on shippers to improve their understanding of the needs of their customers, which has a positive effect on competition.

The group discussed the differences between the constrained and unconstrained approach in terms of their impact on competition. Julie Cox asked how competition would be improved in the case of an unconstrained approach, given that network operators are required to meet all requests for capacity. Ofgem said competition would be improved because shippers would have more options when determining their capacity purchasing strategy. Under an unconstrained approach, shippers would be able to choose to enter into long term capacity contracts backed by firm financial commitments. Ofgem said the constrained approach offered the most benefits for competition because shippers would potentially face stronger incentives to improve their understanding of the capacity requirements of their customers.

*Question 6. How will the ‘expected’ level of NEC be set under the DN incentive scheme? How will this interact with the price control?*

Tim Dewhurst said that as this level may be difficult to assess at first, tight caps and collars may be required in early years (as per entry capacity buy-back incentive schemes). He said that it is possible to “bolt-on” incentive schemes to price controls, without the requirement to re-open the price control. Mark Feather noted that incentive

schemes have been bolted-on during price controls previously, for example in the case of the RGTA reforms.

**Next meeting**

The next meeting will be held at Ofgem's offices on Wednesday 14 July.