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30<sup>th</sup> June 2005**GAS TRANSMISSION – NEW NTS ENTRY POINTS, RESERVE PRICES IN AUCTIONS AND  
UNIT COST ALLOWANCES (UCAs)  
Consultation Document**

May 2005

Dear Nienke

We welcome the opportunity to comment upon the issues raised in this consultation. The need for this consultation arises as a result of the regulatory and commercial arrangements for entry capacity, introduced as part of the 2002 – 2007 price control. These have added considerable complexity and the introduction of entry capacity auctions has not provided reliable long-term investment signals, as widely predicted by shippers. This is recognised explicitly within the consultation document. Transco still relies principally on the planning process, backed up by its statutory obligations, to plan its investment programme. We believe that the continued use of auctions needs to be reconsidered.

UCAGs are clearly a key element of the overall capacity framework. They are used to set the reserve prices in entry capacity auctions and when allied to baseline capacities provide the TO revenue allowance. For the SO investment incentive arrangements, they are used as the reference cost to determine any incentive revenue arising as a result of investment in incremental capacity. Recognising the significant financial commitments, UCAGs need to be stable and predictable for periods that are consistent with investment lead times for both NTS users and Transco.

In turn, this suggests the need for a robust and transparent methodology for determining the UCAGs. It is clear that the methodology to determine long run marginal incremental costs is not particularly well understood by the wider community. The current methodology appears flawed and is extremely sensitive to the model's assumptions, such as expectations of future gas flows or increment size. Indeed at some ASEPs, there are material differences between UCAGs based on 2001 data and those based on more recent data. The result of this is the prospect

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that current reserve prices need to be rebalanced. With uncertainty about future patterns of supply and demand, the need to rebalance may be a regular requirement. While we agree that charges should be cost-reflective, it may be better to avoid step changes in some UCAGs by looking to smooth changes. There is a balance to be struck between frequent changes to preserve cost-reflectivity and the consequent effects on auction behaviour created by the uncertainty. The methodology itself should avoid undermining the allocation mechanism itself and should not create distortions between buyers of capacity pre and post rebalancing.

We recognise that because of changes in underlying model assumptions, UCAGs for existing entry points should be rebalanced to be consistent with those calculate for new entry points. However, both Ofgem and Transco have previously indicated that the entry regime would not be amended for the duration of Transco's current formula period. We believe that this should still be the approach and to bring forward a review would undermine confidence in the arrangements. Any perception of increased regulatory risk may prejudice investment necessary to bring new gas sources into the UK, as shippers/developers may be unwilling to take on longer-term commitments. We do accept that signalling the potential for changing UCAGs will, of itself, influence auction behaviours.

Ofgem has set out two main options for consideration, namely:

1. Review all existing UCAGs before the next long-term entry capacity auction; and
2. Cap UCAGs at new Entry Points and only revise all UCAGs as part of the next price control.

We strongly support Option 2 and believe that the forthcoming NTS price control review should be used to undertake a more fundamental review of the entry capacity arrangements. There are a number of key areas that could be included, including:

- The interactions between entry and exit capacity particularly if a revision to the UCAGs were intended and in the light of any changes to NTS offtake arrangements.
- Development of an enduring approach to rebalancing, balancing the need for cost reflectivity and avoiding distortionary changes to the level of charges.
- Development of an enduring and transparent methodology, including the consideration of alternative approaches, that is consistent between new and existing entry points.
- Consistent application of network investment principles, including the clearly defining who pays and whether connection charges are deep or shallow.

### **Specific Questions**

We have addressed a number of the "views invited" where these are not covered elsewhere in our response.

#### *Chapter 3*

- We would support a fundamental review of the modelling approach, and believe that a detailed "walk-through" of the current process/model at the Transmission workstream would be beneficial for market participants. This would allow a more informed debate about the appropriateness of the current process/methodology and would allow potential alternatives to be considered.
- The 1:20 should be the minimum requirement.
- No methodology is perfect and, on balance, we support the absorption approach as alternatives require complicated assumptions about displaced flows.
- There is a balance between stability and uncertainty of future information.
- UCAGs should be robust to a range of supply/demand scenarios and be broadly stable over a period of time.

## *Chapter 5*

- We agree that it is important to reflect the latest information on changing gas flows in the setting of UCAGs for new entry point.
- We have set out earlier reasons why we believe that UCAGs for existing entry points should not be reset now. On this basis, the auctions should take place in September as planned.
- UCAGs should be set on a cost reflective basis but inevitably, as the underlying data changes, they will diverge from that level. This then raises the question of how frequently they should be revised and this is a balance between undermining the auctions and distorting investment decisions where these are made on the basis of misleading cost data. Benchmarking the UCAGs for new entry points is useful and, where there are significant differences to existing UCAGs, these should be explained and appealable.

## *Chapter 6*

- In the light of experience with NTS entry auctions, we still believe a case can be made for adopting a contractual approach, as proposed for DN entry connections.

## *Chapter 7*

- We endorse the draft principles and agree that they do add clarity.
- In general, we would prefer not to have reserve prices. However, we recognise that within a price controlled world they are necessary to ensure that the monopoly recovers close to allowed revenues, given the uncertainty of outcomes possible under an auction. We have consistently argued that auctions should have no role, as in an unconstrained long-term capacity market, prices should clear at the LRIC. Where all users pay the cleared price, this result could be achieved through non-discriminatory, bi-lateral contracts thereby avoiding the need for complicated auction design. Under this model, the signal to invest is from a commitment to pay for capacity. It is our view that an administered approach is necessary for long-term investment planning, with any long-term allocation process at best informing, rather than driving the process. This has surely been the experience to date.
- As Transco has the data and experience, they should continue undertaking the modelling, subject to Ofgem's oversight.
- Requesting UCAGs should be possible, quarterly and without charge as it is inappropriate to charge shippers for meeting a feature of a regime imposed by Ofgem and Transco.
- We believe that making an annually updated version of Transcost available to interested parties would significantly improve the transparency of the process. It would also allow developers to take an informed view of the UCAs prior to submitting formal requests and reduce the likelihood of new entry point UCAs being challenged.

As Transco's NTS price control is planned for review, it is appropriate to fundamentally consider the regulatory and commercial arrangements for entry capacity. We support a detailed and wide-ranging exercise that includes a critical review of experience with entry auctions to date and whether an alternative approach is more appropriate. In the short-term, we do not support adjusting current UCAGs for the existing entry points and on this basis see no need to delay the auctions planned for September.

We hope these views are helpful and would be happy to discuss them further.

Yours sincerely

By email, so unsigned

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