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Dear Nienke

Gas transmission – new NTS entry points, reserve prices in auctions and unit cost allowances (UCAs)

I am writing in response to the above paper and hope that you will find our detailed comments provided in the attached Appendix useful.

The consultation is primarily seeking views on the proposed methodology for setting Unit Cost Allowances Gross (UCAGs) for new and existing entry points and how best to deal with new entry points seeking a connection to the Distribution Networks (DNs).

However, in considering Ofgem's consultation paper it is apparent that there are some significant regulatory and commercial issues associated with setting and revising UCAGs. In our view, the resolution of these issues is critical to the long-term entry capacity arrangements if they are to achieve non-discriminatory access to the National Transmission System (NTS) and avoid the distortion of the competitive gas market.

In structuring our response therefore, we have focussed initially on identifying these wider implications. Thereafter, we have commented on the specifics of the UCAG methodology set out in chapter 3 and finally, we set out our views on how best to accommodate new DN connected entry points.

In summary, we are concerned that there are inconsistencies in the way in which UCAGs have been set. Furthermore we are concerned that the UCAGs that were set at the time of the price control were based upon Transco's forecast supply and demand scenarios which would now appear to have been fundamentally wrong. We also believe that Transco has not put forward sufficient evidence to justify the changes proposed to the existing UCAGs. We therefore believe that a rebalancing of the existing UCAGs would undermine the key objectives of the long-term auction regime and result in access to the NTS via the auction regime that could be construed as being discriminatory. We also believe there is a risk that competition would be being distorted.

Furthermore, in our view, there are issues associated with the requirement to develop an economic and efficient network. More fundamentally, we believe that there are a number of conceptual issues associated with using long run marginal costs to set reserve prices for existing capacity. We do not believe that this approach is cost reflective.

Given the number of issues we have identified, we firmly believe that any move to revise the existing UCAGs should be delayed until the introduction of the next price control period. In the meantime we believe that UCAGs for new NTS entry points should be based on the best available data on actual costs. Furthermore, prior to introducing any change to the UCAGs we believe there is a need to carry out a wider review of transmission transportation charging arrangements. This should cover an analysis of the success and issues associated with the auction regime, including the setting of NTS entry UCAGs and whether this framework is appropriate in the long term. Our views on a possible revised structure are set out in the attached appendix.

The above proposed review is particularly important given Ofgem's view to date that the NTS exit arrangements should be based upon the entry framework. Importantly, we note that on Friday 24th June Ofgem announced a delay of the NTS exit reform on the grounds that further consultation was required. Given the interactions between the NTS entry and exit regimes and, therefore, the charging arrangements, we welcome this decision and believe that the delay provides an opportunity to examine the NTS entry and exit charging arrangements together.

On a more detailed level, if the proposed approach is to be adopted and UCAGs are to be revised prior to a more detailed review, we have a number of issues with the Transcost model itself. In particular, its dependence on Transco's forecast, the size of incremental step that is used, point to point modelling, and load absorption. We have therefore provided comments on steps 1 to 6 set out in chapter 3 of the consultation paper.

Finally, we firmly support a contractual approach to connecting new entry points to the DNs over one that would mirror the NTS auction arrangements. We have therefore provided our view of a contractual framework that could be implemented in a relatively short timescale.

I hope you will find the comments we have made in the attached Appendix useful. If you would like to discuss any of the points we have raised, please give me a call.

Yours sincerely

Rob McDonald
Director of Regulation

APPENDIX 1

Gas Transmission – New NTS Entry Points, Reserve Prices in Auctions and Unit Cost Allowances (UCAs)

1. Regulatory and Commercial issues with setting and revising UCAGs

Background

Ofgem has explained that following the price control review in 2001, long term entry capacity auctions were introduced as a mechanism to allow shippers to signal to Transco their entry capacity requirements in the longer term against a price schedule associated with providing that capacity. Put simply, if shippers signal that the amount of capacity required in the long term is greater than the amount that is available (the baseline quantity, as defined in the licence), Transco is incentivised to invest in a timely and efficient manner in response to those signals.

Clearly, a key component of the above regime is a shipper's willingness to signal and commit to pay for capacity in the long-term auctions and, therefore, the price associated with that capacity. At the time Transco's incentive regime was introduced, Ofgem set out in the licence ex ante agreed Unit Cost Allowances Gross (UCAGs) for each NTS entry points. The UCAG is an estimate of the unit cost of providing long-run incremental entry capacity at that location. In addition to being a key component of Transco's incentive scheme, these estimates have been used by Transco to set the reserve price for both the long and medium term NTS entry capacity auctions.

In other words, the setting of the UCAG is critical to a shipper in determining its willingness to commit to pay for NTS entry capacity in the long-term auctions. To that end, in our view, UCAG stability is vital if the key objectives of the long term auction regime are to be met, these being:

- To ensure that capacity rights are sold in a non-discriminatory manner that does not distort competition in related markets, such as the supply of gas; and
- To promote the economic and efficient, longer-term development of the NTS to meet the needs of NTS customers and ultimately, gas consumers.

Issues

Against the pivotal role of the UCAG in the long term auction process described above, we believe that Ofgem's consultation has identified three major issues associated with the setting of UCAGs. These are: the consistency of approach to the assumptions and model that are being used to set UCAGs; the definition of the point of connection; and the reliability of Transco's 1 in 20 forecasting.

(i) Consistent approach.

At the time of the last price control review, Ofgem determined UCAGs for all existing entry points (the original UCAGs). They were derived from modelling that had been carried out by Transco using Transcost and were based on a 6mscm/day increment for all terminals.

Since that time, Ofgem has determined UCAGs for a number of other, new entry terminals. However, the approach to setting these new UCAGs has not necessarily been based upon the same assumptions that were used for the original UCAGs. This is illustrated very clearly when looking at the increment sizes that have been used since UCAGs were introduced. When setting the original UCAGs the model used increments of 6mcsm/day. However, Ofgem subsequently determined that such steps could be inappropriate and when setting subsequent UCAGs various increments were used depending upon the site in question. Proposals for new UCAGs requested by Star Energy and Warwick Energy have been based upon a model that assumes incremental steps of 9mcsm/day. Finally, it is suggested that the original UCAGs should now be reset using the 9mcsm/day increment.

Furthermore, it would appear that not even the same costing model has been used on a consistent basis. For example, Ofgem report that the Milford Haven UCAG was based on outputs from Graphical Falcon and not Transcost.

(ii) Point of Connection.

There also seems to be an inconsistent approach to defining the point of connection and, therefore, the extent to which the estimate of the unit cost of providing long-run incremental entry capacity includes the cost of providing a dedicated connecting pipe. This is most apparent when looking at the UCAGs that have been proposed for potential new entry points being considered by Star Energy where for some the cost of the connecting pipe has been included, whereas for others it has not.

(iii) Forecast reliability.

Ofgem has explained that the original UCAGs were based upon Transco's 1 in 20 planning assumptions. In particular, in chapter 5 Ofgem explains that at the time of the last price control review most gas was forecast to enter the network in the north of GB and therefore, reinforcement was assumed to take place to accommodate gas flows from north to south. However, three years later it would appear that these forecast gas flows were incorrect and the assumption is now that gas will flow from the south to the north. As a consequence it is suggested that all of the original long run incremental costs and therefore the UCAGs should be dramatically revised.

Given the fundamental importance of Transco's planning process in setting UCAGs it is extremely concerning to learn that the forecast figures used only three years ago (or indeed, less than three years ago in the case of Garton) appear to have been so badly wrong.

Implications and comparing UCAGs

In our view, the implications of points (i) to (iii) above, at the very least, undermine the key objectives of the long-term auction regime identified above.

(i) Non-discrimination and distortion of competition.

If, as we understand they have, UCAGs have been set using inconsistent assumptions in respect of incremental volumes and connection points we believe that the resulting prices that shippers pay through the auction regime are discriminatory.

It could perhaps be argued that the above flaw could be remedied by revising the original UCAGs and those that have been determined since then using a consistent methodology (ie the methodology that has been proposed for setting UCAGs for potential new entry points being considered by Star Energy and Warwick Energy). However, table 5.2 in the consultation document illustrates the dramatic step-change in UCAGs that would arise from adopting this approach.

This is best illustrated by looking at two of the most strategic NTS entry points, Easington and St Fergus. If the UCAG at each of these terminals were to be revised as indicated, Easington would see an increase in UCAG of some 319%, whereas the St Fergus UCAG would decrease by 100% from being by far the most "expensive" at £0.7040/kWh to zero. In considering these two entry points alone, it is demonstrably clear that if the UCAGs were to be "rebalanced" in this way different and, in our view, potentially more damaging issues of discrimination arise. That is, quite simply, shippers would be paying vastly different prices for the same product on the same day purely as a consequence of the auction regime and the underlying methodology that was adopted in setting reserve prices.

Ofgem has asked for views of when the original UCAGs should be changed, in time for the next round or auctions or at the time of the next price control review? Irrespective of when a rebalance may take place the impact of doing so would, in our view, undoubtedly distort competition in all facets of the gas market, that is the primary and secondary entry capacity markets, the wholesale market and consequently the retail gas market too. This is because a shipper with even a relatively modest capacity interest at St Fergus but which has participated in the long term auctions to date would be exposed to a significant cost of up to several million pounds compared to a competitor that has purchased capacity for the same day but did so after the rebalancing exercise. Clearly, the first shipper in this example is far less able to compete in the market even though the two shippers are using exactly the same facilities on exactly the same day. Furthermore, the capacity bought by the first shipper in the long term would be worthless on the secondary market.

In other words, a rebalancing of UCAGs would, in our view, significantly undermine the economics upon which a shipper has assessed its willingness to buy capacity in the long term and its associated strategy in respect of entering into beach and/or NBP gas supply contracts. Both of these are instrumental to a shipper's downstream strategy in terms of

pricing and market penetration. We also believe it would undermine any confidence that might have emerged in the long-term auction regime and significantly raise the regulatory and commercial risk of the wholesale gas market. This would undoubtedly have a detrimental impact on the cost of gas at a time when prices are at an all time high.

(ii) Economic and efficient development of the system.

We are also concerned that the issues identified above will have a detrimental impact on the economic and efficient development of the NTS. As we see it, any investment signal that Transco has received since the introduction of the long-term auctions would now appear to have been based on incorrect and inconsistent assumptions, albeit with Ofgem's "approval".

However, even if we were to rebalance the UCAG as proposed, comparisons of the existing and proposed UCAGs shown in table 5.2 would suggest that in future shippers would be incentivised to avoid landing gas at the southern terminals. In other words, the approach that is being taken to set UCAGs and the interaction between these UCAGs and the reserve prices is such that there is a risk that there will continue to be a see-saw effect of investment and charges that cannot, in our view, lead to efficient investment decisions.

We are also concerned that consequential investment decisions that have been made on the back of the UCAG and long term auctions would be undermined by a shift change in the UCAGs For example, the future economics of landing gas at the beach and/or decisions relating to the development of new entry points such as LNG import terminals and new storage facilities would have been based upon UCAGs that are now about to change. The competitiveness of these various facilities is therefore potentially at risk.

Conceptual issues in using the Transcost Model

So far we have considered the issues associated with changing assumptions and the impact of varying UCAGs over time. However, we believe that there is a further debate to be had on the appropriateness of using the Transcost Model and resulting LRIC-based UCAGs to, in effect, "set" capacity charges. We consider this below.

Ofgem has outlined that UCAGs are intended to reflect the LRICs of providing additional network capacity and that cost reflective charging is important to ensure that market participants take into account the costs of transmission in deciding where to locate and operate plant. On this basis, Transcost is used to estimate the capital cost of reinforcing the system to cater for Transco's forecast supply and demand scenarios using prescribed increments of capacity. However, the LRICs are also used to generate reserve prices for entry capacity that is already there and is not, by definition incremental. In our view, therefore, the reserve prices generated from the UCAGs cannot be construed as being cost reflective for the use of assets that are already there. Rather they represent costs that would be associated with Transco's *anticipated* gas entry flows irrespective of whether or when they materialise.

On this basis, we believe the model cannot be reflective of the year on year development of the NTS. A year on year approach would be broadly similar to electricity transmission, where the costs are based on the incremental capacity forecast by the model for the year in which the charges apply. The LRIC element gives a locational signal related to a notional cost of additional capacity, but the costs relate to the transmission system cost for that year, rather than a system designed in year 10 for the potential growth and redistribution of generation.

Furthermore, setting marginal prices on what is, in effect, an annualised deep connection charge has further issues associated with it. Once shippers have signed up for capacity in the long-term auction (i.e. a deep charge) assets are presumably installed at approximately this incremental cost and capacity is made available to them. Once this investment becomes a sunk cost, and because of the almost inevitable errors in forecasting, spare capacity becomes available, the new "marginal cost" is zero. In other words second comers get a free ride on the basis of the investment being funded by first comers who have committed to pay the deep charge. This effect is being demonstrated by the UCAGs for St Fergus, and the exactly opposite is happening at the southern terminals.

To overcome these issues, we believe that there is merit in considering a revised approach to entry capacity charging. For example, the introduction of what would be, in effect, a two-pronged mechanism to recovering capacity costs. One that seeks to recover the ongoing “running” costs associated with the sunk assets; and another that seeks to recover the cost of incremental investment. The second element would provide the necessary investment signal to Transco. In our view, this would be consistent with a charging mechanism that is reflective of the physical system that is in use at the time and that is non discriminatory while at the same time providing investment signals for Transco. It would also avoid the risk of the current regime that we are in danger of experiencing whereby shippers are locked in to a price that is subsequently found to be totally inappropriate.

Conclusion

To conclude therefore, we are extremely concerned by the issues that have emerged from the consultation paper. We have outlined our concern that the long term auction regime is, in our view, being undermined by UCAGs that are subject to inconsistent assumptions and policies and that are clearly very dependent upon Transco’s forecast assumptions. We have also highlighted the issues associated with attempting to “rebalance” the UCAGs and the impact this will have on the gas market as a whole. Finally, we have described our concern that LRIC-based UCAGs are being used to recover costs associated with existing assets as well as those associated with incremental investment.

In other words, in our view, there are a number of significant regulatory and commercial issues associated with the long term auctions that need to be addressed as a matter of urgency. We therefore believe that rather than proceeding with the proposed rebalance of UCAGs this year, it would be more appropriate to take stock of what the entry capacity regime has achieved to date and to determine whether there are some modification to the

charging and incentive mechanisms that would better achieve the regulatory objectives. Any future proposed modifications should be subject to a detailed and robust Regulatory Impact Assessment prior to any subsequent changes being made at the time of the next price control review. Indeed, this would be consistent with our understanding of the UCAGs when they were set in 2002, that they would, at the very least, be stable until the next price control review.

Certainly, we believe that Ofgem's announcement on 24th June to delay the proposed reform of the NTS exit arrangements on the grounds that further consultation is required provides the opportunity to carry out such a review. To date, the proposal has been to adopt the NTS entry arrangements at exit. Therefore, given the issues that have been identified in the current paper and the evident interactions between setting NTS entry and exit UCAGs, we believe that there is a need to have a widescale review of NTS charging arrangements.

2. A Method for Setting LRICs and UCAGs

Notwithstanding the views we have set out above that there should be no rebalancing, in this section we provide our detailed comments on the proposed methodology for setting LRICs and UCAGs described in steps 1 to 6 in chapter three of Ofgem's consultation document along with associated issues. Ofgem should not in any way take these comments as supporting the rebalancing exercise.

More detailed comments on steps 1 to 6 of the Transcost Model

Step 1. Ofgem has described that step 1 is to determine the base case for gas flows and physical network form which to consider incremental flows and investment and that this is based on a 10 year timeframe. While a 10-year timeframe may not be an issue in itself, the information associated with the forecast flows of gas that feed into each of those years in step 2 clearly is.

Ofgem has identified that there could be three ways of identifying the base case requirements. First, they could be based on the amount of capacity that has been contracted for in the long term through the long-term auctions. However, it is acknowledged that this is inappropriate since the auctions have not been successful in yielding long term capacity commitments. Second, they could be based on Transco's view of the 1 in 20 obligations. However, at several entry points Transco's forecast 1 in 20 peak day gas flows are significantly below the baseline quantities that Transco is required to sell through its licence obligation. Given these anomalies, it may be appropriate to adopt a more pragmatic approach and we therefore support Ofgem's view that a third option whereby gas flows are modelled on combined approach. That is, where long term auctions signals are above the baseline gas flows should be modelled accordingly. However, where this is not the case, the lower of the 1 in 20 and be SO baseline should be used.

Step 2. We do not understand the rationale behind moving to a 9mscm/day incremental flow rate and are concerned that there has been no apparent justification for doing so. It

may well be appropriate to model this size of increment for engineering purposes if that is the size of investment that is being requested. However, we do not believe that it is appropriate to use this size of increment as the "norm" in the Transcost model to set LRICs. Even if an increment of 9mscm was required at one entry point it would not result in an increment of 9mscm being required between each node on the system. We therefore question the continued use of the "point to point" element of the model and believe that when combined with a move to 9mscm/day it will grossly overstate the likely investment requirements and therefore LRICs. In our view, it would be far more appropriate to model the system on the actual flow patterns of gas, that is the physical reality of the system.

A further aspect of the model at stage 2 that is not clear is at what point in the process do new sites seeking to connect to the process get factored into the model. For example, new UCAGs have been proposed for all of the original entry points using the new model but, there is no indication of whether the potential new storage facilities proposed by Star Energy and Warwick energy have been factored in. Furthermore, we notice that no UCAG has been presented in table 5.2 for Milford Haven; does that mean that Milford Haven has not been included in the modelling?

Step 3. Clearly, if parameters and point to point gas flow assumptions used in step 2 above are used, the costs associated with the corresponding, notional investment requirement will be far higher when compared to the actual costs associated with what is physically required.

Step 4. We have already indicated that, in our view, a consistent approach is required to determine whether the costs of a connecting pipe are to be included in the system reinforcement costs or whether connecting pipelines should be seen as part of the one off capital cost of making the physical connection to the NTS.

Step 5. As we have already indicated under step 2 above, we do not believe that it is appropriate to retain the "point to point" approach of modelling gas flows. For example, we do not believe that it is credible to assume, and therefore include in the model, a scenario where an increment of 9mscm/day of gas will flow from an entry point in the south of the country to an exit point in the north of Scotland. Quite clearly, exit points in Scotland will use gas that enters the system at the northern entry terminals including St Fergus where Transco's 10 year statement shows that peak input does not significantly reduce until 2013. In our view it would be far more appropriate to model the system on the actual flow patterns of gas, that is the physical reality of the system.

We also note that the Transcost model assumes the marginal cost of building new entry capacity is the same across the country since a straightforward average is applied. We believe this assumption requires justification and if correct, NTS allowed revenue for such investments needs to be determined on the same basis.

Step 6. We do not understand the basis upon which costs have been allocated between entry and exit. At best it would appear to be subjective. It is also difficult to comment when only a few weeks ago, Transco released a pricing discussion paper (PD18) stating

that the proposed methodology for setting NTS exit capacity UCAGs is based upon a 6mcsm/day (i.e. rather than 9mscm/day as consulted upon in this paper). Indeed, it would appear that the NTS exit UCAGs proposed in PD18 and the NTS UCAGs presented in this current consultation have been developed in complete isolation. We do not believe that this is appropriate given the interactions between entry and exit. It would therefore appear that a further explanation is required of the interaction between the entry and exit UCAGs.

Balancing the network.

In order to balance supply and demand in the modelling process, Transcost assumes that every increment of supply is matched by an equivalent increment of demand. That is, demand is scaled up to match incremental supply. We do not think this is appropriate and believe a far better and more realistic approach would be to substitute supply. That is, where an additional increment of supply is being modelled at one location corresponding decrement(s) should be modelled at other entry points. Our preference for adopting the supply substitution over the load absorption approach is that demand forecast is generally more accurate and it is demand levels that "drive" supply. Furthermore, it would seem more relevant given that Transco's obligation to develop its network is associated with meeting demand, not supply.

Transparency

Given the sensitivity of models such as Transcost to the underlying assumptions and input data, we believe that it is vital that market participants have access to the model and a detailed justification of the model inputs. This would appear to be particularly important given the shift change in UCAGs indicated in table 5.2 and the significant impact these proposed revised UCAGs would have on all aspects of the gas supply chain.

3. Indicative UCAGs for the new entry points.

We have not commented specifically on this section of the consultation paper since we believe that there are a number of policy issues that must be addressed before any meaningful new UCAGs can be set. For example, appropriate and consistent incremental steps, how to treat the costs associated with connecting pipes and other issues associated with the Transcost model.

4. Entry points connecting to DNs

Ofgem has asked for views on how best to accommodate the connection of new entry points to the DNs. In particular, whether it is appropriate to mirror the NTS entry capacity arrangements or whether a more simple, bilateral contractual route is preferable.

We firmly believe that a contractual arrangement is by far the most appropriate. We do not believe that it is in the interest of developers, shippers or ultimately the benefit of customers to introduce the very complex entry auction arrangements at the DN level. In our view, the cost of doing so would be considerable and, as Ofgem has indicated in

paragraph 3.11, the benefits of the long-term auction regime are as yet unproven. We have therefore set out below our view of a more simple, contractual framework.

In accordance with existing DN charging methodologies, a shallow connection policy would be adopted and a consistent policy applied to the treatment of connecting pipelines. In our view, connecting pipelines should be treated as part of the connection assets (or sole-use assets) and, therefore, recovered from the developer as part of the construction or site works charge. A developer's commitment to pay for this pipe work as part of the connection charge would also contribute to assessing the developer's long term commitment to the project and therefore ensuring the continued economic and efficient development of the wider network by the DN. We consider further the aspect of signalling commitment later in this section of our response.

In addition to entering into a site works agreement to cover the installation and cost of sole use connection assets, the developer would be required to enter into a network entry agreement or something equivalent such as a DN Storage Connection Agreement. This agreement would set out the operational parameters within which the entry point/storage site would operate and would include for example, gas quality issues, ramp rates, maximum injection rates etc. We believe that this agreement could be sufficiently agile to allow more flexible entry rights in order to avoid, for example, significant network reinforcement costs that theoretically could arise from a storage site injecting at times of low demand but which in practice are unlikely to occur.

Assuming some sort of economic test is met, consistent with a shallow connection policy any system reinforcement costs would be capitalised and included in the DN regulatory asset base and recovered from shippers in accordance with the cost reflective, non-discriminatory charging methodology that applies to all connected points to the DN. If the new entry point were to be used by a number of shippers (for example, a new storage facility) an allocation agent would be required to allocate the charges between the relevant shippers on any gas day. This would be consistent with NTS connected storage/entry points as well as shared supply points.

The question arises as to what would happen if the economic test was not met and system reinforcement costs were greater than those associated with the economic and efficient development of the network. As with existing connection arrangements, the "excess" system reinforcement cost would become part of the site work cost of connection.

We also believe that there would be merit in considering a "pay or flow" type arrangement that would in effect, underwrite the investment if the volume of gas flows assumed in the economic test did not materialise. In this situation the developer would enter into an agreement to compensate the network owner for the loss of revenue from the expected use of the facility over a certain period. Whether this would apply to all connections or only to those above a certain threshold is for consideration.

We firmly believe that the above commercial framework is far simpler and a more pragmatic approach to take when considering future arrangements for DN connected entry points when compared to the NTS entry arrangements. Furthermore, it is based on

arrangements that are found elsewhere within the existing gas transportation framework and should not, therefore, be unduly difficult to implement or costly in terms of system development. We also believe that it would be relatively quick to put in place and would avoid the complexities and issues we have identified with setting UCAGs discussed earlier in this response.

Finally, Ofgem has suggested that if a contractual route were to be adopted it may be appropriate to consider imposing new licence requirements obliging DNs to treat applications for embedded entry points in a non-discriminatory manner. We do not believe that this would be necessary on the grounds that the licencee is already required to conduct its business in a manner that is non-discriminatory and that does not distort or prevent competition.