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## Transmission Price Control Review – Second Consultation December 2005

Dear Robert

We welcome the opportunity to comment on the issues raised in the Transmission Price Control Review second consultation. This response reflects the views of RWE Npower and the UK based business of RWE Trading GmbH.

### General Comments

In responding to this consultation we note that Ofgem's primary purpose for this Second Consultation is to identify and seek views on policy options for determining the appropriate form and scope of the new price controls. On this basis, we consider it premature to provide detailed comments on options set out in the document. Rather, we will focus our general comments on higher level issues raised by the user commitment framework and the TPCR objectives that underpin these options.

#### *User Commitment*

Although an approach based upon user commitment may have merits, the document is not clear about how it would be applied practically and whether a common model would be implemented across all licensees. There are a number of ways that user commitment can be demonstrated and, for example, the Advanced Reservation of Capacity Agreements (ARCA), which require a commitment to pay transportation charges, could be applied more widely.

The gas entry capacity model is highlighted as a mechanism for network users to signal their demand for capacity, yet the document provides no quantitative evidence to demonstrate the increased investment efficiency compared to a more administered approach. Ofgem concedes that the gas entry approach raises questions about its complexity and effectiveness and we would argue that applying the mechanism to far more nodes would significantly increase the level of complexity and reduce its effectiveness.

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There is no intrinsic requirement for consistency between the arrangements for the gas and electricity networks. There are fundamental commercial, physical and operational differences between gas and electricity transmission and entry to and exit from the networks and we see no compelling reason why different arrangements should not persist providing these meet the needs of network operators and network users. We therefore welcome Ofgem's comments in this regard.

#### *TPCR Objectives*

We believe that cost reporting by the transmission licensees needs to be more transparent, particularly under the various SO incentive schemes. This is reflected in the approach based on identifying the key cost drivers for the business and related reporting. We support the continued incentive for delivering efficient operational costs and standardisation of reporting as introduced under DPCR4.

We note that considerable investment in transmission assets may be required over the duration of the next price control period. This will include, amongst other things, new transmission lines in Scotland and the extension of the GB system to serve offshore wind farms. We believe that efficient and effective delivery of these works is required and we would support thorough and wide-ranging consideration of potential investment plans as part of the price control review.

#### **Form and Structure of Price Controls**

We continue to believe that RPI-X is appropriate for providers of monopoly transmission services. This should be the principle form of control and any incentive schemes should be set to reinforce efficiency only at the margin. Transmission price controls have been progressively unbundled which improves transparency, correctly allocates costs and enhances efficiency of those services that could be provided competitively. We continue to support this approach to the extent that there is reasonable expectation alternative service providers would emerge.

Our preference would be for stability so we would support price controls that adjust automatically rather than setting them in the expectation that they will be reopened. In our view, the expectation of a price re-opener encourages network operators to abdicate the management of those risks that they are best placed to manage. The principle should be that only Force Majeure related events should permit a re-opener.

We share Ofgem's concern that capital expenditure should be efficient and timely, but believe that the transmission licensees are best placed to judge the likely manner in which the system could develop, albeit that Users can inform the decision making processes. The network owners will need to balance market intelligence gathered from a variety of sources, with investment decisions that are driven by the need to comply with licence and other statutory obligations. In these latest proposals, Ofgem highlights the costs associated with the over-provision of capacity and the risk of, but to our knowledge has never analysed the level of any stranded assets. Although the quoted headline number of £150m is included for illustrative purposes, the reality is that it equates to around £1.50 per customer for each of the five price control years. The under provision of capacity and effects on supply can be equally costly. For instance, Ofgem noted in its Impact Assessment<sup>1</sup> on the costs of interruptions caused by supply restrictions due to off-spec gas increased gas costs by tens of millions for relatively few days disruption, due to the impact on wholesale prices.

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<sup>1</sup> Modification Proposal 0049 "Optional Limits for Inert Gases at System Entry Points" Impact Assessment November 2005

A consequence of any uncertainty means that it may be more economic to face short-term constraints in order to reduce the risk of stranded assets. However, this requires that SO incentives to minimise such constraint costs are better designed and do not conflict with the incentives on the TO. For instance, in gas NGG has two different reasons to value interruption, as the TO to avoid pipeline investment and as the SO to manage operational constraints. The trade off between constraint management and deferred investment must be explicitly recognised so that an optimum investment programme can be delivered. We would support explicit and transparent reporting of this trade off to ensure that the relevant licence objectives are being met.

We have previously commented on the level of remuneration achieved historically under the various SO incentive schemes and are keen to ensure that NGET and NGG are not over-rewarded for their performance and believe that Ofgem should use the TPCR to undertake a fundamental review of the incentives, including their structure and the targets set. It should also be used to resolve any information asymmetries between Ofgem and the network operators. The review should consider, inter alia:

- Reducing sharing factors to around 10% going to the SO;
- Reducing the level of costs subject to any incentive scheme;
- Introducing market-based, contestable service provision where possible;

### **Gas Incentive Options**

Ofgem has put forward a number of options for how the regimes for gas entry and exit capacity could be amended to address their concerns with the existing arrangements. At this stage, we believe that is inappropriate to provide detailed comments, but we would note the following.

In the absence of an option to replace gas entry auctions with an administered approach, our strong preference would be to retain the status quo as far as possible. Defining the baselines and obligations on the TO to deliver the baseline is clearly a fundamental component and Ofgem's proposals in these areas indicates that, in their view, a number of the parameters within the framework are currently not correctly specified. Ofgem argues that this has resulted in shippers having artificially reduced incentives to signal demand for capacity in the long-term auctions. However, we think that it is equally wrong that the auction design results in shippers facing artificially increased incentives to buy long-term capacity. The allocation mechanism should not be set up in anticipation of an expected outcome and then amended if it does not materialise.

We are still not convinced by the need to introduce fundamental reform to offtake arrangements and our view is that Direct Connects (DCs), including storage and interconnectors and Distribution Networks (DNs) are different and use different NTS services. For instance, storage sites use both entry and exit services; DN's use the NTS to transit gas for use by end-users connected to their network and as an alternative to investing in local distribution or storage capacity on their own networks; and the shippers to DCs procure transmission capacity to meet demand at the site.

Ofgem has brought forward proposals for fundamental offtake reforms and it is disappointing that they have discounted analysis undertaken previously that showed the practical problems and additional complexity associated with moving away from a single, administered, nodal capacity product. Transitional arrangements address many of Ofgem's concerns and we believe that an Impact Assessment on whether further change is required should be undertaken as soon as possible. It is premature to attempt to assess the options at this stage when the need for change has yet to be demonstrated and in any case, it is not possible to provide meaningful

comments until the relationship between the product, baselines and incentives have been more fully developed.

Ofgem also raises the need to introduce capacity substitution mechanisms to optimise existing network capacity before incremental investment is undertaken. This would be through an explicit substitution incentive for nodal baselines and implicitly where baselines are defined on a zonal basis. The concept may be relevant to network owners as they optimise capacity, but not at the shipper level. Although we support efficient investment by the TO, the extent of actual substitution must only be at the margin. Therefore, the capacity regime would be one based around financial rather than physical rights which could create significant buy-back costs for the SO, particularly where the contractual entitlements move away from the physical reality of the network. The extent of these costs, which will inevitably be borne, at least in part by network users, needs to be quantified. In addition, payments under the substitution incentive need to be high in order that NG NTS will substitute capacity rather than investing, with the assets subsequently being included in its RAB.

The proposal to decouple revenue drivers from reserve prices raises some concerns. Although it would allow more frequent and therefore more cost-reflective price setting, it introduces more uncertainty. It is not clear that such price uncertainty is consistent with an approach to encourage long-term commitment. We believe that participation in long-term allocations will be undermined by uncertainty in prices year on year or else a risk premium will be included. This additional uncertainty will compound that which arises from shippers' uncertain exposure to buy-back costs associated with entry capacity holdings and the recognition of price changes that will result from recalibrating the parameters underlying the NG NTS pricing model.

We agree that in principle there may be a case for two different buy-back arrangements, one for day-to-day operational reasons and handled through SO commodity and one to manage late delivery of new network investment. We still believe that the entry capacity product should be "clean" and not include the uncertainty associated with this avoided investment liability. Removing this uncertain liability should encourage willingness to purchase long-term capacity rights.

### **Electricity Incentive Options**

It is refreshing that Ofgem acknowledges that the solutions for gas and electricity do not have to be the same. There are significant differences between the two fuels with limited entry points to the gas transmission system and a degree of in-built storage facility whereas electricity has many entry points and the product is transmitted instantaneously at a constant frequency and voltage.

Price controls are a long established and integral part of the regulatory framework that provide for protection of consumers' interests and, at the same time, appropriate incentives for companies to meet their obligations in an efficient and co-ordinated manner. The approach does run the risk that investment may be made that results in stranded assets. We agree this risk can never be completely eliminated, however, experience to date, where the regulation of monopoly networks has provided an adequate proxy for competition, suggests that it can be managed effectively.

The consultation document states that one of the failures of the current approach of a revenue driver based on total connected generation has not coped with the changing demand for network capacity and has required a re-opener in the current price controls. This conclusion is arrived at following the re-opening the current price control due to the unanticipated rise in the connection of renewable generation in Scotland. However such a re-opening of the price control happens

very rarely and in general the current approach has worked well. On this basis a clearer cost/benefit analysis is required before the detailed issues contained within the consultation can be considered.

The high level description of the User commitment model sounds superficially attractive in that it could create options for NGET to prioritise the provision of additional capacity and to consider trade-offs between investment and buy-back costs using economic criteria. However, before this approach can be seriously evaluated, a number of detailed design issues would need to be addressed. Indeed, it is clear that the design of the framework for gas entry auctions has yet to fully bed down with a number of developments proposed which further raises the question of what would be implemented for NGET. The result is likely to be a more complex revenue restriction as there would be a requirement to develop an incentive scheme for NGET's buy-back costs.

These issues, together with the requirement to co-ordinate the timing of the amendment of other documents and Codes where, inevitably issues of transition would arise, raises the question as to whether a detailed framework can be worked up before the Price Control implementation date of April 2007.

We have provided our initial views on a number of the policy issues raised by Ofgem. However, we remain to be convinced of the need to make fundamental changes to arrangements that have in general served the markets well over a number of years. At this stage, we are unable to make detailed comments on options that are still at an early stage of development. We hope these views are helpful and if you wish to discuss them further please contact Terry Ballard on 01793 892715 or Charles Ruffell on 01793 893983.

Yours sincerely

Charles Ruffell  
Economic Regulation