

Robert Hull
 Director, Transmission
 Office of Gas and Electricity Markets
 9 Millbank
 London
 SW1P 3GE

Your ref
 Our ref LOG117
 Name Charles Ruffell
 Phone 01793 89 39 83
 Fax 01793 89 29 81
 E-Mail charles.ruffell@rwenpower.com

28th April, 2006

Transmission Price Control Review – Third Consultation March 2006

Dear Robert,

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

General Comments

Ofgem argue that much of the investment during the next price control and beyond will be driven by decisions made by network users, in particular new electricity generators, gas importers and gas storage schemes. This has implications for the proposed design of the price controls, which feature increased use of revenue drivers and revised access arrangements based around users making a financial commitment to back their requests for future access rights.

Together, these have shaped Ofgem's current thinking on the design of the gas entry and offtake and electricity incentive proposals that are set out in this 3rd consultation document. On gas offtake, we welcome the collaborative approach used by Ofgem to refine its proposals. Although we would still prefer retention of the status quo, the straw men that have been developed do represent less complex solutions than previously proposed at the time of gas DN sales. However, we are not sure that the problems these solutions are attempting to address are as material as Ofgem contends. We agree with Ofgem that its proposals for reform of the gas entry arrangements represent a fundamental change. What is less clear is that the rationale for such reforms has been demonstrated. Although the electricity transmission companies have indicated that significant investment is required over the next five years, we do not believe that fundamental change to the present arrangements is necessary. Any development of the electricity incentive arrangements should be incremental and draw on experience of other initiatives in the market.

Price Control Design

As stated in our response to the second consultation, we believe RPI-X is an appropriate mechanism for providers of monopoly services. It has worked well to date. A five year period remains a sensible balance between certainty and

RWE npower

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

T
 +44(0)1793/8
 9 39 83
 F
 +44(0)1793/8
 9 29 81
 I
 www.rwenpowe
 r.com

Registered
 office:
 RWE Npower plc

being able to accommodate changes in circumstances. However whether this form and period remains appropriate will depend on the refinements and changes in approach mentioned in the document. A number of the proposals could lead to a reallocation of risk with possible unintended consequences. If this is the case, the present arrangements may prove limiting.

The Transmission licensees have submitted proposed investment programmes over the next five years of £6.5bn, which is a 150% increase over allowances in the current period. On the face of it these sound excessive and we expect Ofgem to undertake rigorous analysis of the efficiency of both the load and non-load related elements of them. This is particularly important with regards to pensions, environmentally driven costs and where above inflation cost increases have been signalled.

We also expect Ofgem to ensure that an appropriate level of transparency is maintained regarding NGG's cost projections so as to enable shippers to make informed responses throughout the consultation process. Once RAVs, allowable revenues and incentives are finalised these should be sufficiently transparent to allow shippers to monitor NGG performance during the price control period and project the likely impact this will have on transmission charges.

The investment programmes cover both replacement expenditure for existing assets and new expenditure to meet the changing patterns and locations of sources of both gas and power. The new price controls are designed to reduce the risk that these investments lead to stranded assets. We share Ofgem's concern that capital expenditure should be efficient and timely, but believe that network operators should not abdicate the management of those risks that they are best placed to manage. A number of the proposals shift responsibility and therefore risk away from the network operators and onto network users and, particularly in gas Ofgem appears to be taking less of a role in approving the efficiency of investments ex ante with deep SO incentives proposed for incremental capacity investment.

In our view, it is the transmission licensees that are best placed to judge the likely manner in which the system could develop, albeit that network users can inform the decision making processes. If efficiency is to drive investment in the transmission systems, it is inevitable that there will be congestion at certain times. A system that is entirely free of congestion at all times suggests over investment. The issue therefore is to balance an acceptable level of congestion against a signal for additional investment. However, this requires that SO incentives to minimise such constraint costs are better designed and do not conflict with the incentives on the TO. The trade off between constraint management and deferred investment must be explicitly recognised so that an optimum investment programme can be delivered. Explicit and transparent reporting of this trade-off is required to ensure that the relevant licence objectives are being met. We would support a thorough and wide-ranging consideration of the structure of SO Incentives and their interaction with the TO price control.

Gas Entry Incentives

In general, we accept that the idea of an entry capacity substitution mechanism to optimise existing network capacity before incremental investment is undertaken has some merit. However, we do not believe that it will work in practice and, if introduced, will seriously undermine the long-term auction process as shippers will perceive increased risks, both from the change to the current market rules and the proposed new arrangements themselves.

Capacity Release Mechanism

Ofgem correctly identifies that the proposals represent a fundamental change. However, the document does not adequately justify why such a change is necessary. There is no assessment of the extent of any incremental capacity investment undertaken within the current price control period that could have been avoided under a substitution model. Although Ofgem contends that the current arrangements are inflexible, National Grid Gas NTS (NGG) is already able to optimise capacity between ASEPs, albeit close to the day of delivery and subject to licence and incentive constraints.

We believe that changing the market arrangements after a relatively short period will create uncertainty about the stability of any arrangements going forward. Shippers have already made long-term decisions based around one set of market rules and there may be doubt, in the light of the proposed changes, whether they will now be able to secure the capacity they need. Lack of an obligation to release nodal capacity arguably creates an artificial incentive to participate in the long-term release to reduce the risk of substitution removing capacity in the short-term. If this is the true purpose of the proposals then it should be made explicit and a solution developed within the current framework.

With nodal baselines, network users can assess the availability of entry capacity by comparing the baseline to the quantity sold and/or held back. The option for shippers to make an informed choice when to buy is an important feature as shippers may legitimately wish to buy capacity over different time frames dependent upon the type of entry point and the nature of their contractual arrangements. For instance, purchases for a storage facility may be made differently than capacity for a long-term beach gas supply contract.

The obligation to release a nodal baseline will be replaced by a system wide capacity-release obligation. Under this, capacity availability will be less clear cut so shippers will rely on a published methodology and interpretation of NGG's behaviour under its incentives. We are not convinced that the information available will be sufficiently transparent to permit an accurate assessment of how NGG is complying with its licence obligations.

A system wide capacity release obligation at entry also conflicts with Ofgem's favoured approach of setting nodal baselines at exit. Whilst we would argue strongly that it is not appropriate to adopt consistency just for consistency's sake, this is one area where we believe the entry and exit regimes should be aligned.

Buy-back Arrangements

We agree that there is a case for two different buy-back arrangements, one for day-to-day operational reasons and handled through the SO commodity charge and one to manage late delivery of new network investment, structured through bi-lateral contracts.

Ring-fencing the potential costs associated with late delivery of incremental capacity provision is correct, but we believe that the mechanism should not allow NGG to avoid exposure to costs. Where it decides to release incremental capacity in response to its incentives and on the basis of an approved methodology then it should be exposed to the buy-back risk. Our concern is that the presence of default arrangements, particularly where there are zero buy-back prices set, will in practice mean that NGG will be unwilling to enter into bi-lateral agreements. If this is so, shippers may not be able to cover the opportunity costs that arise as a consequence of late infrastructure provision. These costs are unlikely to be simply the avoided capacity payment. The shipper will face the costs associated with any gas contract take-or-pay commitments together with needing to source gas elsewhere. Finally, the design of the buy-back arrangements should not permit NGG to shift the project delivery date backward at its own discretion, with no recompense, as this will leave the shipper covering all the risk.

Charging Arrangements

It is inevitable that Unit Cost Allowances (UCAs) set at the beginning of a price control, and the reserve prices based upon them, will become less cost-reflective across the course of a five-year price control period. There is always a balance to be struck between price stability and cost-reflectivity. What is not clear at present is how volatile reserve prices set annually will be compared to reserve prices adjusted every five years as the UCAs are reset. Work in the Gas Transmission Charging Methodology Forum (GTCMF) is helping to inform this, but there is still analysis to be completed. Key to shippers understanding the indicative year-on-year changes and developing their bidding strategies will be the transportation pricing model that will be provided. This too is subject to further development in the GTCMF and it is hard to provide definitive comments at this early stage. However, any mechanism needs to avoid setting prices that fluctuate wildly between periods such that purchasing decisions taken are not materially undermined. If this is not the case, it will further undermine shippers' confidence about long-term commitment.

Incremental Revenue Driver

Ofgem is proposing to introduce a more automated mechanism to reward incremental investment above a trigger level, although it is unclear whether an Incremental Entry Capacity Release methodology or similar will still feature in the process. In addition, the current linear revenue driver, based upon the UCA, may be replaced with a more complex non-linear function. The proposal is intended to simplify the current complex set of calculations of the various types of capacity revenue, but with the drivers varying by location and with different trigger levels at each location it may be equally complex.

The design of the incremental revenue driver must only reward actual incremental investment, not capacity that is substituted. The incentives faced by NGG for substituting capacity must not conflict with its incremental capacity incentives. Again, the methodology used to determine this needs to be transparent and robust. In all likelihood it will be difficult for any party but NGG to understand fully the workings of this incentive in practice. We would prefer that Ofgem had more oversight in this area.

We accept that the ideas in this area are under development and will be informed, in part by NGG's network modelling exercise. However, it will be necessary to understand the interaction between baselines funded under the current revenue allowance and the proposed trigger levels to be funded under the new price control.

Gas Offtake Incentives

Ofgem's thoughts on the future gas offtake regime to apply during the next price control period follow on from ideas developed in advance of gas DN sales and from discussions at the Enduring Offtake Working Group (EOWG).

We welcome Ofgem's constructive engagement with gas market participants at EOWG and believe this has led to arrangements being developed which are less complex than those previously proposed which broadly speaking shippers should find easier to operate under. However, despite this we are still not convinced that the changes being proposed will result in any appreciable benefit in operational and investment efficiency compared to the current regime. We are also disappointed that Ofgem have yet to provide any evidence to illustrate the magnitude of some of the perceived problems they believe these arrangements will help to overcome despite many requests from shippers.

Transitional Period

We agree with Ofgem that NGG should face incentives to deliver incremental investment through the entire period of price control. These should be reflective of the degree of user commitment required from shippers/developers for incremental exit capacity.

It is also appropriate to scrap the “foregone charges”, “exit capacity investment” and “NTS buyback” incentives and to retain the “Constrained LNG” and “15 day interruption” incentives as Ofgem are proposing. This will prevent NGG earning incentive revenue for little risk or benefit to system efficiency or to shippers, whilst encouraging NGG to act in an efficient and non-discriminatory manner where their actions could be significant. However the case for retaining the “15 day interruption” incentive is marginal in the event transitional baselines are set at practical maximum physical basis.

In both the transitional and the enduring periods we believe flat capacity baselines should be set at a nodal level based on the practical maximum physical offtake capability at each node. GDN flexibility in the transitional period should also be zero, although we do not believe the concept of flexibility (as a separate product or as part of an integrated “expanding flexibility product”) is necessary, appropriate or cost justifiable based on current operational experience.

We are concerned that the preliminary transitional baselines for firm and interruptible TCCs (as shown in Annex 1 to Appendix 12) may in fact represent the current level of booked capacity rather than the practical maximum physical offtake. We would welcome greater transparency as to how these numbers have been derived. We also would welcome discussion at EOWG as to how firm and interruptible capacity that is booked in the interim and transitional periods will be treated as regards the enduring baseline, which is of particular relevance under a prevailing rights allocation model.

Enduring Offtake Arrangements

The enduring offtake arrangements discussed in this consultation require further thought and development at EOWG such that Ofgem can consult on the total offtake/incentive package in a more detailed and “joined up” manner as part of their next scheduled consultation.

Notwithstanding our previous comments about whether there is a need for fundamental change to the existing offtake arrangements our views at this point are as follows.

We share Ofgem’s views that a combined “expanding” capacity product has considerable merit over a two product mode in terms of reduced complexity. If the slope of the line of the expanding flexibility entitlement (relative to offtake) is set at a level that is truly reflective of current shipper and GDN entitlement/usage, and system capability/diversity, this will allow many shippers to passively manage their flexibility requirements through short term flat capacity purchases. It also avoids the risk of NGG making inefficient investment in response to dubious and uncertain investment signals, or earning unwarranted incentive revenue.

We also recognise the need for a proportionate level of user commitment for incremental capacity investment and believe that the “prevailing rights” model is the most appropriate method of securing this. However, we are concerned that user commitment seems to extend to prevailing capacity rights in cases where shippers seek extra capacity on top of their existing requirement. This could deter shippers from seeking small increases in capacity and significantly increase a shipper’s exposure to exit overrun penalties.

The proposals put forward by NGG appear to us to be based on the worst case incremental exit capacity investment scenario. As such their proposals are too rigid to fit in with the planning, commitment and

build cycle of all the asset types that require gas offtake capability, and this is one of the difficulties that arise from assuming that all users should be subject to the same offtake arrangements.

One way of over-coming this may be to, as well as creating a common default user commitment process, allow users to opt into bilateral arrangements directly with NGG. These may have different investment lead times, early/late delivery provisions and termination notices/payments than the common default process, but would retain the same level of user financial commitment.

Further discussion and development of these proposals is required at EOWG, but in the event the parameters currently included within NGG's strawman prevailed (i.e. 4 year financial commitment to prevailing capacity, 3.5 year investment lead time and 2.5 year capacity reduction lead time) this represents a significant transfer of risk away from NGG to asset developers. It also represents a marked change to Ofgem's previous interpretation of their shallow connection policy.

1 in 20 obligation

Whilst we recognise the logic of Ofgem's minded to position with regards to the 1 in 20 obligation and the fact that NGG should only be remunerated to the extent there is an associated user, we need to understand more fully how these tie in with licence obligations, allocation mechanisms (i.e. prevailing or finite rights model) and incentives before we can fully support this.

Substitution obligation

We are not convinced of the need for an exit substitution obligation on NGG, and believe that the instances where substitution will take place are likely to be rare. Bearing in mind capacity reduction lead times and long term buy back arrangements are envisaged under the enduring arrangements we believe these are sufficient to ensure any likely substitution possibilities are taken account of, without the need for a specific licence obligation. We also have concerns that shippers will have very little transparency over when and how substitution opportunities may arise which may force them to make non optimal capacity decisions. A substitution obligation may also undermine the "prevailing rights" model and lend support to a "finite rights" approach, which we strongly oppose.

Buyback

We agree that many of the issues faced at entry and that the entry proposals aim to address will be similar in nature to those that arise for the enduring offtake regime, and support consistency in principle across the two regimes. Administered buyback prices may be appropriate under a default user commitment process providing they are set at a level and within an incentive framework which drives NGG to deliver incremental capacity in a timely manner. However we believe there is scope to adopt different buyback arrangements within individual bilaterally agreed incremental investment agreements.

Payment flows

We do not at this stage see any problems with implementing Ofgem's preferred payment flow model in parallel with the introduction of the enduring offtake regime providing detailed breakdown of TEC charges (at DN Exit Zone level) are included on GDN invoices. However, this subject has not been debated in any detail to date. Once we know exactly how GDNs intend to amend their current invoice formats to accommodate this change we may wish to change our initial view.

Electricity Incentive Options

We agree that locational revenue drivers would seem appropriate but note Ofgem's suggestion that revenue drives should be supplemented with other mechanisms in exceptional circumstances. Although there may be merit in this approach, it seems to undermine the argument in the earlier consultation that more sophisticated revenue drivers were required in the light of the TIRG experience, itself an exceptional event. This suggests that in practice the value of revenue drivers may be limited given the lumpy nature of transmission investment.

We support Ofgem's wish to ensure that investment decisions are made in an efficient and timely manner. This may require consideration of current transmission access arrangements. However, any change to the arrangements should be informed by the earlier work carried out under the CUSC governance arrangements by the Transmission Access Standing Group that identified significant implementation issues associated with decentralised trading. We suggest the following criteria should be adopted for any proposed scheme:

- It should not be overly expensive to implement and should not require complex system development;
- It should not result in significant financial commitment from existing generation which has, by connecting to the system, demonstrated financial commitment;
- It should not alter the balance of risk between parties without the commensurate adjustment to revenues;
- It should increase the incentive on parties to request connection to the system within realistic timescales without a perverse incentive merely to reserve capacity.

We look forward to commenting further on these issues when the final report of the Access Reform Options Development Group (ARODG) becomes available.

Network Reliability

We have consistently argued that the current Network Reliability scheme for electricity transmission is both ill conceived and unnecessary. NGC are subject to licence conditions that require it to operate their system in an efficient, economic and co-ordinated manner and at all times to plan, develop and operate their system in accordance within the Transmission System Security and Quality of Supply standard. Therefore an explicit scheme is not required. We would support Ofgem if it wished to develop a 'penalties only' scheme which supplemented these measures providing that penalties were in line with licence obligations. We take issue with the view that the penalties are likely to be small however, as this pre-judges the nature and form of the penalty.

We hope these views are helpful and if you wish to discuss them further please contact Terry Ballard on 01793 892715, Steve Rose on 01793 892068 or myself on 01793 893983.

Yours sincerely,

Charles Ruffell
Economic Regulation