

Lewis Hodgart
Policy Analyst, Gas Distribution
Ofgem
9 Millbank
London
SW1P 3GE

Mark Freeman
Contract Manager

Mark.freeman@uk.ngrid.com
Direct tel +44 (0)01926 656218
Direct fax +44 (0)01926 656620

www.nationalgrid.com

28th June 2006

Dear Lewis,

Response to consultation on initial thoughts on the reform of interruption arrangements on gas distribution networks

Thank you for the invitation to respond to the Ofgem consultation on the initial thoughts on the reform of interruption arrangements on gas distribution networks. We have structured our response to include some high level comments on DN Interruption reform, a response to the questions outlined in the consultation document and a response to the impact assessment information request which is included in a confidential appendix. This response is sent on behalf of National Grid's distribution business.

General comments

At the outset we would like to confirm that we support the reform of the current DN Interruption arrangements, which would allow for the efficient decision trade off between interruption and capital investment, the latter primarily removing the need for network sensitive loads. Whilst the current arrangements have some strengths and weaknesses we consider that there could be benefit particularly if the reform ensured that payments were only made in those areas of the network where interruption was a foreseeable event. Further benefits would result from interruption regime and NTS exit reform incentivising DNs to make efficient trade offs between booking additional NTS exit capacity and entering into contracts for demand interruption. We think there is scope for introducing arrangements that allow more flexibility and increase customer choice whilst allowing GDNs to determine their interruption requirements and efficiently trade-off the procurement of capacity products, including investing in their own networks.

We do however also have some reservations in that a change of this magnitude inevitably creates uncertainty and we would recommend a cautious approach for implementation, particularly in setting incentives and the periods for which they apply. Based on previous experience, for example with the NTS exit capacity incentives, there was sufficient uncertainty that incentives were only set for a limited time period and we would recommend that incentives are only set for one or two years allowing for review and learning from experience before setting them for a longer time period. We also understand that there will be some reticence from customers regarding this reform and that we, and all GDNs, must work together with the industry to put together a pragmatic proposal that is not unduly complex.

In terms of wider issues we must also be cognisant of the fact that there are different types of interruption and that this reform is only about transporter interruption and not shipper (commercial) interruption or emergency arrangements. Shippers and consumers may argue that the issues with commodity (price of gas) are more pressing than those concerning capacity issues that this reform seeks to address. The impact assessment will need to consider the impact on emergency arrangements and setting of storage monitor levels through having a potentially smaller interruptible

population. Also, a relationship has been made between changing the structure of distribution charges (to increase the capacity:commodity split) and DN interruption reform. Although there may be distributional impacts if a full capacity discount were maintained whilst increasing the capacity element of the charge, we believe that it is feasible to introduce a structure of charges that would allow an increased capacity element during the transitional period when interruption reform is being introduced.

Chapter 2: Principles for reform

1. Has Ofgem identified the key weaknesses of the current interruption arrangements for GDNs ?

Whilst we agree that Ofgem have generally identified the key weaknesses of the current interruption arrangements we would like to make the following comments under the headings in the Ofgem consultation.

GDNs lack of control of the amount and location of interruption

Whilst the amount of interruption is not rationed at present, the option of being interruptible is not open to all customers, sites having to satisfy certain criteria including having an AQ greater than 200,000 therms and being daily metered. There is also a consideration whether the site has switched from being interruptible to firm in the last twelve months.

Under the current arrangements all Network Sensitive Loads must be interruptible in order to maintain the integrity of the network under high demand conditions, thereby avoiding the need for additional capital investment. By their nature they require specific investment to make them firm, therefore they have specific demand triggers when they should be interrupted and like other interruptible loads are eligible for further compensation payments (discounts) should they be interrupted for greater than 15 days. Whilst some loads have never been interrupted, and on average they are interrupted by transporters once or twice a year it should be remembered that since the inception of Network Code all winters have been warm when compared to the seasonal normal temperatures.

Too much interruption is made available increasing costs for customers

To reiterate the point made above there is a natural limitation on the numbers of interruptible loads – this is governed by the number of loads that meet the criteria to be interruptible. In terms of encouraging customers to be interruptible at present the trend is actually towards a decreasing number of interruptibles. It is also worth pointing out that there are two types of interruption, that instigated by transporters and that instigated by shippers, otherwise known as commercial interruption. The latter is far more prevalent than the former.

Lack of investment signals

(see also response to Chapter 4 on incentives later in this document)

We note Ofgem's point that at present the value of interruption to customers is not explicitly revealed. However to premise the current capital expenditure overspend in this price control period on an inefficient trade-off between buying interruptible rights and buying NTS offtake capacity is incorrect. The current overspend arises primarily in the areas of domestic connection and service replacement, both of which have little bearing on interruptible rights and NTS offtake capacity. We would also note that whilst customers can switch between firm and interruptible at a year's notice this is not a frequent activity and is not a large factor in determining whether we should invest in new capacity or rely on the present population of interruptibles.

Poor signals about customers' costs of being interrupted

We note that the present regime does not identify the value of interruption to customers and hence the price that customers would be willing to be paid to be interruptible. However we recognise that as the number of interruptibles is decreasing it would suggest that similarly attractive terms would need to be offered for customers that are needed to maintain their

interruptible status.

Lack of product flexibility

We agree that under the present interruptible arrangements, based on a single annual 45 day product, there is a lack of flexibility in what can be offered to, and sought by, customers.

2. To what extent do interested parties consider the current arrangements have significant strengths, and if so, what are these strengths ?

Whilst recognising that the current interruption arrangements may have some weaknesses it is also worth recognising that the arrangements do have some merit. The arrangements have benefited from being relatively simple to administer with a clear framework that both transporters and customers can operate within. The arrangements have also been developed within this time period to create a more efficient environment; for instance the regime has been changed so that now loads receive a full discount on their capacity charges for being able to be interrupted for up to 15 days and receive a further payment if interruption exceeds this amount. The regime has therefore been able to cater for all interruptible loads including those that are network sensitive and therefore more likely to be interrupted.

The key to the interruptible reform will be whether the benefits of the new regime will outweigh the implementation and on-going costs and whether the risks of reform can be managed appropriately.

3. Do you agree with Ofgem's key principles for reform ?

We broadly agree with the principles for reform. However, as with all major change programmes, we believe that the benefits must be demonstrated to outweigh the costs of implementation. The case will need to be made on the basis of a robust cost/benefit analysis and that customers are incentivised to bid for interruptible rights and transporters are incentivised to make appropriate trade-offs and investment decisions.

Chapter 3: Implementing Reform

1. To what extent do respondents consider that the model so far developed by the GDNs meets Ofgem's principles for reform ?

As proposer we are naturally supportive of the model so far developed in that we think that it provides a mechanism for transporters to be able to make efficient trade-offs in capacity products whilst also allowing customers some choice in the interruption terms they would prefer. This belief is of course built on the premise that we will have appropriate incentives in place to make those efficient trade-offs and to be able to manage any associated risk of moving towards an approach where the transporter determines the interruption it needs and the customer indicates the terms (price and duration) it requires. Whilst NTS Exit Reform is still being developed we also believe that the proposed DN Interruption regime could be implemented initially with NTS exit reform following at a later date.

We are also aware that the GDN proposal requires further development. In particular we are aware of customers concerns with regard to the locational definition of the products, the potential impact on the timescales for negotiating supply contracts and the additional complexity that any new arrangements may bring. We will endeavour to work closely with the industry to develop a regime that is both workable and meets the aspirations of all concerned.

2. Has Ofgem identified all the key interactions with the enduring offtake reforms for the NTS ?

Whilst Ofgem has identified many of the key interactions with NTS enduring offtake reform we would like to make the following additional points:

- Under the present proposal for NTS Offtake Reform Users are expected to pay the prevailing price for capacity i.e. the price at the time of utilisation. However, under DN Interruption Reform a perceived key benefit is in being able to trade-off the cost of interruption with other capacity products e.g. NTS offtake capacity; in order to make these efficient trade-offs GDNs will need to know the price of NTS offtake capacity at the time of making the decisions (i.e. three years ahead) and be locked in to that price
- In terms of timing we agree with Ofgem that interruptible rights should be sold ahead of purchasing NTS offtake rights
- We also agree that the leadtime for purchasing NTS rights should be the same as the leadtime for selling interruptible rights. Having a different leadtime for the two options would undermine our ability to optimise acquiring NTS exit rights and interruption rights.
- It is not apparent why Ofgem think that the sequencing is not as important in 2007 as any other gas year and why GDNs are more unlikely to indicate a requirement for incremental capacity (for 2010) in this gas year as opposed to any other gas year

Chapter 4: Incentives for the GDNs in the next price control

1. What is the appropriate form of an incentive on GDNs for the purchasing of interruption ?

In the consultation Ofgem has outlined two options to incentivise GDNs to make efficient purchases of interruption services:

- a) An allowance should be included in the overall RPI-X price control
- b) Set specific incentive outside the RPI-X price control with caps, collars and risk sharing factors

Given the uncertainty surrounding the costs and prices associated with reform, we believe that setting a specific incentive outside of RPI-X is more appropriate, allowing for sufficient protection through the use of appropriate caps and collars. In particular, we note that because of the potential locational market power within GDNs such as a Network Sensitive Load, they should be prevented from extracting a monopoly rent to the detriment of other market participants.

We do not believe that incentivisation as part of RPI-X is appropriate. The RPI-X allowance is a “top down” allowance which is typically not transparent on a line by line basis. To this end, it may not be possible to identify explicitly the allowance given for interruption costs. Furthermore, in the absence of re-openers in the current control, should costs outturn above the allowance, the GDN's are likely to face undue and unlimited risk.

Setting the allowance

In terms of the setting of the allowance we agree that this should be based on historical use of interruption services but this should be used in the context of a 1 in 20 winter and normalising this over a series of winters of varying severity taking into account the probability of their occurrence. With respect to the assumptions made about the cost of interruption whilst the matrix approach does allow transporters some control over the price of interruption offered this obviously has to be considered relative to the cost of investment and the likelihood of customers being attracted to the terms in the matrix. An approach whereby Users offer a price

based on their assessment of the value of interruption would provide a better indicator of the price a User is willing to accept for interruption but this information would not be available until the regime was in operation and the incentive allowance had been set.

We note Ofgem's comment that over the current control period that in a number of cases capital expenditure has exceeded the capital allowance by a factor of two. As Ofgem is aware a great deal of information is being provided through the current price control period on the reasons for this and it is incorrect to suggest that the discrepancy is due to the lack of signals between trading off interruption and buying NTS offtake capacity. Capital overspends would be expected as a result of having too few interruptible contracts rather than too many.

Duration of Incentives

In view of the uncertainty and in order to mitigate against any potential distortion between GDNs purchasing interruption rights or other capacity products that caps, collars and risk sharing factors may introduce it is suggested that the incentive should be set for an initial period of one or two years allowing time for review before the incentive could be set for the remainder of the price control period.

Impact on capital investment plans

It should also be noted that the reform of the current interruption arrangements is likely to have a knock on impact on any capital investment programme in the short to medium term. We have already mentioned the importance of network sensitive loads and the ability to interrupt in order to avoid substantive capital investment. In some instances, it is possible that some loads will use price as a signal to avoid interruption and hence contract costs which, when combined with locational power, could be in excess of the cost of investment over a particular period of time. In such scenarios, investment may be more efficient.

The implications of interruption reform on our investments plans will be included in our main BPQ submission as part of the overall price review process.

2. Do respondents support the continuation of a similar incentive to the transitional incentive for GDNs purchasing of NTS offtake capacity ?

Whilst we do not consider that this question is part of DN Interruption Reform per se we would make the following comments. There has been recent prolonged debate about the capacity products in the interim, transitional and enduring exit capacity regimes. We are of the view that product definition and incentive regimes need to be considered in the round and that the reasons for the purchase of short term capacity need to be considered. Whether short or long term purchases are included in incentives would not provide a long term solution if there remain shortcomings in capacity definition – the effects will need to be well understood before any such regime should be implemented.

Appendix 2: Impact Assessment information request

5. Ofgem would like for each of the last three years to provide a list of occasions on which they have nominated interruption by providing the:
- **Date of interruption**
 - **Reason for interruption e.g. supply demand balancing or constraint relief. If both factors then the GDN should provide the subsequent information requested under this question split between interruption for supply demand balancing and interruption to relieve a constraint**
 - **Number of sites interruption on each date**
 - **Total volume of interruption on each date**

Included in the Appendix

6. For all occasions of interruption listed in response to question 5 where the GDN had a choice of more than one site that could have been interrupted to address the supply demand balance or relieve a constraint, Ofgem would like each GDN to explain how it chose which site to interrupt

Included in the Appendix

7. Ofgem would like each GDN to confirm the total number of sites it has available and volume of interruption it has available for this gas year [2005/6]

Included in the Appendix

8. Ofgem would like each GDN to identify any implementation and ongoing costs that they would expect to incur as a result of reform of the interruption arrangements on their networks. When making the estimate of additional costs, GDNs should use their own model for reform explained in chapter 3 as the basis for estimating any additional costs compared to the current arrangements. These costs should only include additional costs that would be incurred as a result of reform the interruption arrangements on their networks, but which would not otherwise be incurred. In particular, costs arising from NTS enduring offtake reforms should not be included. Ofgem would like customers and shippers to separately identify implementation costs and ongoing costs and for each to state the:

- **IT systems costs**
- **Staff costs, including assumed additional FTEs and cost per FTE; and**
- **Other costs**

Costs should be in 2006 prices with implementation costs stated as a total and ongoing costs stated as an annual cost.

Included in the Appendix

9. Environmental impact

Where the gas transporter enters into an interruption contract rather than reinforcing the network, there will be a benefit to the environment of avoiding the disruption associated with installing a gas pipeline.

10. Security of Supply

Whilst it is difficult to quantify the effects of reform it is not envisaged that reform would adversely affect security of supply. Whilst customers are presently able to switch between being firm and interruptible at 12 months notice this is not a frequent activity and DNs are able to size the transportation system accordingly. Under the GDN proposal where transporters would be able to determine the volume of interruption required, offer more flexible interruption terms and trade off capacity products security of supply should not be compromised.

11. Health and Safety

National Grid is not aware of any impact on health and safety of the proposals for DN Interruption Reform.

12. Distributional Effects

Assuming that the new interruptions regime operates in the desired manner, the distributional effects will be beneficial with the payments from gas transporters being focused on those customers most likely to be called upon to interrupt. In particular the issue of customers receiving a discount but rarely, if ever, being called upon to interrupt would be resolved.

13. Impact on small businesses

Under the present interruptible arrangements sites that are daily metered and that have an AQ of at least 200,000 therms are only eligible to be interruptible. Under the proposals for DN Interruption Reform it is not proposed to change the eligibility criteria and therefore all loads that consume less than 200,000 therms per annum will remain as firm. Consequently, we believe the impact of reform on small businesses would not be significant. This is an issue that could be re-visited if significant numbers of Smart gas meters are installed at small business premises.

14. Risks and unintended consequences

Other than the risks outlined previously in this response National Grid is not aware of any further risks or unintended consequences from the reform of interruption arrangements.

If you have any queries, or would like to discuss this response, please do not hesitate to contact me.

Yours sincerely,

Mark Freeman