Northern Gas Networks Limited
Registered in England & Wales No 5167070
Registered Office
1200 Century Way Colton
Leeds LS15 8ZA

Tel: 0113 251 5000

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

Dear Lewis

Initial thoughts on the reform of interruption for GDNs

Please find attached NGN's response to Ofgem's initial thoughts on the reform of interruption arrangements on gas distribution networks. We have structured this to address each of the questions that the consultation asks. It is difficult at this stage to be specific on appropriate incentives or implementation costs until there is more clarity on the detail of interruption reform implementation.

NGN supports proposals for interruption reform. NGN recognises the merits of a market based approach, but there is a danger that the market is too complex for the full reform envisaged and that there will be unintended consequences that may result in increased rather than decreased costs in some instances. Consequently interruption reform should be implemented in as simple a way as possible.

Because many of the capacity restraints on the network result in a single network sensitive load (NSL) in a zone, these NSLs will have substantial market power to set interruption prices at levels potentially significantly above the current cost of interruption. Thus the expected reduction of costs to firm loads may not occur as envisaged and the cost allowance for interruption needs to recognise that DNs will have to accept interruption bids up to the full cost of reinforcing the network to eliminate NSLs.

Please do not hesitate to contact me if you would like any further clarification of our attached response. If it would be helpful, I would be happy to meet with you to explain and discuss our views.

Yours sincerely

Alex Wiseman
Regulation Director

NGN response to initial thoughts on the reform of interruption for GDNs

Principles for reform

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

NGN broadly concurs with the weaknesses that Ofgem has identified in the current interruption arrangements. However, one of the rationales for reform is that "GDNs do not control the amount or location of interruption that is available", although of course GDNs do control the amount and location of interruptible capacity for network sensitive loads (NSLs).

NGN agrees that the ability of end users to move from interruptible to firm and vice-versa with not less than twelve months notice does not lend itself to GDNs being able to plan confidently, as the required longer term investment signals are by definition not available. Improved signals are important to gain the required long term clarity in this area. To that end the GDPCR must be set based on clear, consistent assumptions on the outcome of interruption and offtake reform and associated pricing and incentive schemes.

The consultation states (paragraph 2.9) "that in a number of cases actual capital expenditure has exceeded the allowance by a factor of two. This indicates the scale of interruption that would be affected by better signals about the trade offs with interruption and buying NTS offtake capacity". It should be noted that NGN's excess expenditure in this area was almost exclusively in repex and connections work, therefore the impact on the scale of expenditure from interruption reform is likely to be small.

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

One of the strengths of the existing arrangements is the clear equitable nature by which interruption is called by Networks on end users who are equally placed to relieve a constraint. Under the proposed new arrangements a small price differential could see one end user frequently being interrupted whilst an end user in near proximity (with a higher exercise price) may never be interrupted.

This example highlights the strength of the current arrangements. It is simple in its design and application and is readily understood by all industry participants. Its usage does not require significant IT investment nor does it require significant analysis to decide whether to opt for an interruptible service.

The certainty of interruptible sites is a strength from which Networks can confidently forecast their 1 in 20 requirements. Similarly end users have the certainty that existing transportation terms can be budgeted for in future years without having to re-tender on an annual basis.

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

NGN concurs that shippers and end users should have greater freedom to offer interruptible services and that network owners should not need to accept unneeded interruption. If an efficient market system can be derived then investment signals will result in more efficient capex. However, there is a danger of sacrificing simplicity for a complex system that is difficult for GDNs to manage appropriately and for shippers and end users to understand.

End users with interruptible contracts will indeed in the future have a much greater likelihood of being interrupted. It is incumbent on GDNs and end users in these situations to ensure that interruption is appropriately communicated and managed.

We have no evidence of undue discrimination in the current system, and as indicated earlier there is a danger that after reform a few end users could be interrupted more often rather than the rotation amongst end users that currently occurs.

NGN agrees that there is a strong interaction between GDN interruption reform and NTS enduring offtake reform and the two must be considered in tandem. Note also that each GDN has specific differences which should be accommodated when detail is being assessed.

Implementing reform

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

GDNs have prepared a combined matrix approach to interruption, but until the details are clarified and agreed with shippers, the precise nature and impact of the approach is difficult to forecast.

The usage of certain sites currently requires a number of tranches of interruption (up to nine at one site in one instance). This adds additional complexity to the three geographical levels of interruption referenced in the consultation.

NGN believes that each GDN should be able to offer supplementary tenders for additional interruption services outside of the standard three year cycle. Such additional tenders could run at any time providing the GDN made the tendering process available to all interested parties. This would increase flexibility between using available exit or interruption or storage to manage capacity.

The requirement for called interruption to be carried out by the end user is arguably more important than under current arrangements, hence any failure to interrupt should carry charges beyond those in place for merely carrying out the requirements of an interruptible contract. However, there may need to be clarification of the contractual relationships as GDNs are contracting for interruption with shippers not end users.

However, there is a danger of "gaming" by large end users. NSL end users could bid for interruption up to the cost of investment required to increase network capacity appropriately. This bid may be significantly more than the current interruption payment and also significantly more than the loss of value to the end user of not having firm capacity. Hence total costs to firm end users could, conceivably, increase after interruption reform.

Under the new regime there needs to be clarity that the 1 in 20 obligation is still fit for purpose and that it covers the selling of all capacity as firm followed by buy back of interruptible capacity.

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

The interactions between purchase of interruption and exit capacity are complex and there may be an element of iteration. It appears sensible to sequence interruption purchase ahead of NTS capacity bookings as the consultation suggests as there is an opportunity to retender for interruption. However, a GDN can offer as much interruptible product as it chooses, but has no certainty whatsoever how much (if any) of this product may be elected for by end users. At the extreme therefore a GDN could be faced with its Firm 1 in 20 requirement for 2010 increasing by the full load factor of its existing interruptible load. Consequently, only after the results of the GDN interruptible process are known can a GDN make an informed view on booking its NTS Exit capacity requirements. If a GDN did have to retender for interruptible rights, it may be perceived as a distressed buyer and hence have to pay substantial premiums for interruptible purchases.

The timing of when in each year the information for interruption and exit is requested has yet to be finalised. This is a key element of the process to be established early in the production of business rules supporting the timetables spanning interruption and exit services.

Incentives for the GDNs in the next price control

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

It is difficult to assess the appropriate form of incentive until there is more clarity for both interruption and exit reform. However, it is important that the allowance for interruption purchase is set so that an efficient GDN can earn its allowed cost of capital. It needs to be recognised that interruption and exit reform substantially increase the risk of operating a gas network and this should be reflected in the cost of capital.

In paragraph 4.4, Ofgem makes the point that the price level offered by end users to GDNs is not a cost that is wholly outside of the GDN's control. Whilst GDNs can of course set the parameters of any matrix, at this stage the appetite of end users for interruption outside of its current prescriptive format is unknown, in particular when end users realise that there is an increased likelihood of being interrupted if their bids are accepted. As stated in the consultation and identified earlier in our response, these end users have locational market power. There is a real danger either that bids for interruption are not forthcoming or that the bids are priced based on the cost of reinforcing the network to eliminate NSLs. Consequently, the interruption incentive should be based on the cost of reinforcement required to eliminate NSLs.

There is likely to be significant uncertainty over the likely cost of interruptions suggesting that incentives should be set using a cap and collar system. An early review of incentives should be included in proposals so that incentives can be reconsidered if they are not achieving their objective.

One element of risk that is particularly relevant to interruptible schemes is the weather/demand patterns. In offering interruption, GDNs would reasonably assume an atypical seasonal demand with some variant built in for higher than average demand. Consequently, there may need to be a weather adjustment to the expected cost of interruption.

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

Paragraph 4.13 within the consultation identifies some concerns about the scope of the current NTS offtake capacity transitional incentive. It may be helpful to clarify the process of capacity bookings and usage.

A GDN, in booking longer term capacity via the OCS process requests its 1 in 20 capacity requirement together with its diurnal storage requirements. GDNs have not historically requested the day to day operating flexibility (for the benefit of GDNs **and** National Grid Transmission) that has typically been provided via the OPN process. NGN, in establishing its OCS requirements for 2005/06, continued its long standing approach on the basis that the incentive was set ignoring operating flexibility usage and consequently was not a factor within the incentive regime. Consequently, any revision to the incentive regime must also revise the assumptions made on capacity requirements.

It is unclear what risk National Grid NTS faces through the continued steady state usage of OPN requests outside of the annual OCS booking window by GDNs. It is also important to identify how many incidents of offtake specific or offtake group OPN bookings above the anticipated OCS level are at the request of NTS or as a consequence of behaviour on the NTS (for example to relieve a temporary NTS constraint, or facilitate summer engineering works).

The use of operational flex is typically required at a group of offtakes, not at a specific offtake point. Ofgem has recently requested that GDNs assess the configuration of groupings best serving this requirement on their networks so that an assessment can be made of potential operational flexibility requirements in subsequent years. Whilst there may be merit in establishing some baselines around this operational flex usage it is important that any revised incentive takes full account of OCS booking levels, investment decisions and the NTS and GDNs' safety cases.