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Lewis Hodgart
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Ofgem
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28 June 2006

Dear Mr Hodgart,

Initial thoughts on the reform of interruption arrangements on gas distribution networks.

I am writing in response to the above Consultation document published on 16th May 2006. This response includes;

Appendix 1 which incorporates our general comments related to the consultation (Part i) and our answers to the specific questions raised in the consultation document (Part ii); and Appendix 2 which is a separate confidential attachment that details further response to a selection of the specific questions raised in the consultation document.

For the avoidance of doubt this letter and Appendix 1 can be published.

If you require any further information please contact me on 029 2027 8539 (sarah.williams@wwutilities.co.uk) or Liz Spierling, Commercial Manager-Transportation on 029 2027 8549 (liz.spierling@wwutilities.co.uk).

Yours sincerely

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APPENDIX 1

Part i-
General Comments

Incentives
WWU is committed to an incentive Regime that delivers an appropriate number of incentives on items which are within its control, providing that it does not compromise the Network's legal obligations in maintaining security of supply. Incentives should not be complex as this tends to require a significant level of effort to understand them or to deliver the relevant output – instead, the effort should be concentrated on delivering the required business result. An increased number of individual incentives, with their various interdependencies, increases the overall level of risk to which the business is exposed and should therefore be reflected, all else being equal, in a higher cost of capital. There are specific comments on incentives within the Chapter 4 responses.

Customer Commitment
As a consequence of the changes within the structure of the UK gas business, WWU intends to issue a consultation on the ARCA required for connection to the DN. It is envisaged that the main changes will be to reduce threshold consumption and include provision for recovery of all transportation charges following enduring Offtake regime changes. These changes are designed to ensure that the DN is able to manage risk and, where appropriate, to share this with affected parties.

Investment Lead Times
WWU accepts that for the majority of construction projects a 36 month lead time is appropriate and indeed in some cases may be able to be completed in less time. There will be instances, however, where 36 months is insufficient, for example where there are particular environmental issues, planning consents or engineering difficulties. WWU would like to develop a model, consistent with that used by National Grid, which would allow individual projects to have approved lead times exceeding 36 months where that is appropriate.

Part ii-
Answers to Questions in Consultation Document

Chapter 2

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

Whilst the current regime has led to more interruptible contracts than are required to meet the present supply / demand balance, it has driven DNs to plan and carry out a lower level of investment than might have been otherwise needed. DNs have historically assumed that, for planning purposes, 100% interruption at peak 1 in 20 conditions will be available. The actual level of interruption required over recent years, however, has been much less due to the mild winters experienced in the UK. Thus the current arrangements have probably led to some end consumers choosing to enter into interruptible contracts with a strong expectation that they will not have their supplies interrupted, in other words seeking the associated reduction in transportation charges without anticipating delivering any real benefit to the system or other users The reduction they receive, which should in theory provide recompense for the expense of installing alternative fuel supplies or for the risk of shutting down operations, could be seen as creating additional costs for consumers because there is no real benefit to them from the increased transportation charges that result, if the network does not need the additional interruption.

In addition, in order to manage specific locational issues DNs have had to apply restrictions to customers designated as Network Sensitive Loads (NSLs). These customers are exposed to a greater likelihood of interruption without receiving any additional pricing compensation in comparison to other interruptible loads.

Ofgem is correct in asserting that these arrangements do not provide appropriate investment signals to the DN'ss, nor do they appropriately price the service offered to the end consumer. However it is unclear how any link can be derived from any perceived capital overspend and the current interruption arrangements. Theory would indicate that an over supply of interruptible contracts would lead to a reduction in investment, if the planning model assumes 100% interruption under peak conditions. The real problem is the use of administered rather than market prices combined with the ability of customers to choose interruption at such prices, without any tradeoff between interruption and other methods of ensuring security of supply.

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

WWU agrees with the Shippers and consumers who support the current regime that an over supply of interruption available within the market may deliver increased security of supply. However this needs to be considered against the mild weather conditions experienced over previous winters. During the last 3 winters WWU has initiated 14 days of Transporter Nominated Interruption, which is an extremely low use of such contracts.

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

WWU agrees with Ofgem's key principles for reform, the most significant being to provide efficient investment signals to DNs. The real issue is to ensure that the mechanisms to deliver reform are efficient, effective and represent value for money. The delivery of the reforms must drive the right business behaviour and be equitable to all parties in the industry. This is not always easy to achieve, and one example is those instances where the DN becomes a distressed buyer when a locational constraint can only be resolved by one customer. Arrangements need to be put into place to avoid the monopoly rents that would ensue should such customers seek to exploit such a situation.

The pricing methodology applied to interruption will require careful consideration. Unless pricing mechanisms are flexible and appropriate pricing signals are generated, a pure trade off to avoid capital expenditure or long term exit capacity commitment could lead to interruption services being priced incorrectly, which would in turn deliver too much or too little interruption capacity. Likewise if a customer becomes aware of the cost of the investment that would be required if interruption were not an option, it will want to be compensated up to that amount, a standard problem in markets which have relatively large step changes in prices between producers.

Chapter 3

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

The DN model meets Ofgem's principles for reform in the following areas:

- DN's freedom to contract and product flexibility – the model anticipates that DNs will identify the locations, volumes and duration of interruption required. The market will then respond and provide appropriate price signals, taking into account the increased likelihood of interruption being invoked in any year.
- Efficient investment signals – DNs will have the opportunity to consider all of the options available to procure capacity. The price signals for interruption can be considered alongside the NTS exit capacity charges and the cost of investment within the DN. This comparison will allow the DN, and Ofgem, to assess whether investment is being carried out in an economic and efficient manner.
- Reducing the scope for undue discrimination – provision of universal firm capacity (with appropriate lead times and end user commitment) reinforces a non discriminatory connections market. Consumers requiring an interruptible service will have to participate in the market process for connected loads.
- Promoting competition – as the cost of interruption will reflect its market value there will be no cross subsidy of these customers from the generality of customers. The level of interruption available to the market may be less than that currently contracted for and therefore customers who require this service will be exposed to a competitive process.

The implementation of the DN Interruption reform should not prevent a Shipper from entering into interruption arrangements with consumers to fulfil their own supply / demand requirements. WWU would collect DN exit capacity charges from the Shipper who would need to arrange any discount or compensation with its Shipper's customer. That said, there could be difficulties in terms of what contractual relationship, if any, it is appropriate for a

network to have with end users, and if there is no such relationship ensuring that interruption commitments endure if the customer changes its supplier.

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

It is appropriate that interruption reform is considered in conjunction with enduring Offtake reform. As one of the principles for reform is to provide efficient investment signals it is critical that the DNs can consider their options – simply stated these are "buy" (NTS exit capacity), "build" (DN construction) or "sell" (interruption rights). If enduring Offtake and interruption are uncoupled this principle and the associated benefits will not be delivered. There are still benefits to implementing interruption reform, however, as it would help to identify the market for these services and deliver a cost reflective product. In addition, there would need to be recognition of the challenges facing the DNs in demonstrating that any capital expenditure that was an alternative to buying NTS capacity or selling interruption rights was both economic and efficient.

Chapter 4

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

If DNs are able to use the sale of interruption as part of the "buy, build or sell", the only incentive required will be for the DN to demonstrate to Ofgem that the resultant decisions provide the most appropriate (and hence economic and efficient) method of developing the network. Incentives work best when the company incentivised has the ability to respond to the incentive and has assurance that its behaviour will be rewarded or penalised under clear rules. Therefore in accordance with the generally accepted principles of incentive regulation, Ofgem should set ex-ante capex allowances, within the price controls, based on the highest cost of the three options, that is buy, build or sell. The DN can then take a rational and economically efficient decision on how to satisfy the requirement, which is some cases will mean that it outperforms the incentive. At the next price control review this is clawed back for the benefit of customers. This is entirely consistent with the current regulatory incentive regime.

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

Under the enduring Offtake reform DNs will be required to make a long term user commitment to exit capacity. It is assumed this will take the form of a "take or pay" type arrangement between the DN and NTS. Whilst it is unclear how the payment flows between Shippers and Transporters will work, we assume that Transmission Transportation charges will include a pass-through of the NTS exit charges. Therefore the difference between the capacity booked through the long term process and that purchased by the Shippers will be the area required to be incentivised. In addition the relationship between long and short term bookings is an area for consideration; whilst the Shippers are exposed to reconciliation within the NDM market, the relationship between Shipper nominations and DN daily capacity bookings is not clear. Within the UNC there is provision to apply an overrun charge to the DN exit capacity, but there is no mechanism to apply this to the NDM market and this will require clarification.

The Ofgem proposals imply a general movement of risk from NTS to the DN'ss, and we do not think that is appropriate. For example, the NTS will be requiring user commitment from DNs for capacity reservation, but the DNs have limited ability to back off these arrangements with Shippers, particularly when the capacity relates to the NDM market. In addition the change in payment mechanism will lead to the DN bearing the full risk of Shipper default unless the element relating to NTS transportation charges is clearly designated as the responsibility of the Transmission transporter. The incentive framework established for both the DNs and NTS are linked and therefore the DN is potentially at risk if the relationship is not balanced. This increased and new risk needs to be recognised either through higher allowances, greater pass back of an appropriate proportion of the risk to NTS or through a higher cost of capital.

Impact Assessment Questions

Question 5: Ofgem would like each GDN for each of the last three years to provide a list of all 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 interrupted on each date; and**
- **the total volume of interruption on each date.**

Question 6: For all occasions of interruption listed in response to question 5 where the GDN had the 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.

Question 7: Ofgem would like each GDN to confirm the total number of sites and volume of interruption it has available for this gas year.

Responses to questions 5 -7 are included in the CONFIDENTIAL appendix.

Question 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 of 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.
Ofgem would encourage GDNs to provide additional commentary to explain their cost estimates

Xoserve will be submitting a response to the Initial Thoughts document. This has been discussed with the DNs and those costs have not been included in this response. The xoserve submission includes the methodology for allocating the costs between the DNs. Any additional Xoserve costs need to be fully allowed for in any price control proposals for the GDN.

WWU have considered costs which over and above any previously identified for enduring Offtake reform and which are also additional to the SOMSA replacement project. Areas where costs would be incurred have been identified as follows:

- Network Planning – identification of location, volume and duration of interruption required
- Commercial – assessment of tenders
- Pricing – transportation income adjustment
- Finance back office, expansion of Transportation Income and Credit Control team
- System Operation – exercise of interruption ensuring equitability

These costs will be made up of staff and system costs. The quantum of these costs has not been assessed at this time, but it is unlikely to exceed that required for Enduring Offtake Reform.

Question 9: Environmental impact - Ofgem welcomes views on the environmental impact of reform of interruption arrangements on the GDNs, and whether any impact is likely to be significant

The main environmental impact would be in the construction phase should we decide to invest rather than offer interruption contracts. This is closely monitored through the DN's planning process, and by the local council and the DTI where planning consent is required. The only other environmental impact would be as a result of increased throughput if interruption was not used; the effect of this would be very small.

Question 10: Security of supply - Ofgem expects that reform of the interruption arrangements on the GDNs will lead to an improvement in the security of supply of the gas network through improved signals about the need for investment in new capacity, diurnal storage or other forms of flexibility. It is difficult to measure quantitatively impacts on security of supply, so Ofgem will focus on a qualitative assessment. Ofgem welcomes views on the likely impact of reform of the interruption arrangements on the GDNs on security of supply.

Reform of interruption could lead to more significant investment which in turn will improve security of supply in that area of the network. For it to be effective, we will need to understand in advance how Ofgem will determine whether or not the three way tradeoff between buy, build or sell decisions has been assessed properly, especially as there are likely to be areas of risk and uncertainty within the assessment.

Question 11: Health and safety - Ofgem welcomes views on the impact on health and safety of reform of interruption arrangements on the GDNs, and whether any impact is likely to be significant.

No comment.

Question 12: Distributional effects - Ofgem expects that reform of the interruption arrangements on the GDNs will lead over time to a lower overall cost for customers, including lower charges to be paid to the GDNs. If an approach similar to the GDNs' model is adopted, whereby all customers are firm and GDNs determine the quantity of interruption to buy, all customers will be liable for firm exit capacity charges, with payments for being interrupted depending on which customers the GDNs choose to contract with. The distributional impact of this change is difficult to forecast precisely in advance and will depend on annual quantities and prices of interruption. It will also depend on the changes made to the capacity: commodity split of distribution charges. Ofgem will use the best available information at the time of the IA to assess the distributional effects. Ofgem welcomes comments on the likely distributional effects of reform of interruption arrangements on the GDNs.

Currently Shippers are invoiced via Xoserve on behalf of NTS and DNs The proposed changes will increase the volume and value of invoices sent out by DNs and result in a new relationship between them and the NTS. This obviously has to be implemented and then managed and this will have cost implications. There will be changes required to Xoserve invoices and updates to both NTS and DN internal processes. It is difficult to quantify these costs at this time without knowing the specific model proposed and hence its implementation requirements. The value invoiced from the DN will increase due to the increased invoice volume and value generated by taking on current NTS invoice types. The overall cost to customers will only fall if the components of allowed revenue fall.

Specifically related to this topic, if overall NTS and DN capital investment falls, then the Allowed Revenue elements associated with this element will fall. This would be offset by the cost increases identified above. It is our view that with the increase in volume and value of Invoices generated by the DN driven by bringing NTS charge items will result in a more risky model for DNs. We believe the Commodity / Capacity Split within the structure of transportation charges shopuld focus on Collected Revenue better reflecting the cost bases of DNs in relation to fixed and variable costs and Allowed Revenue sensitivity to volume fluctuations, rather than increasing or decreasing charges to customers *per se*. Ensuring that all connected customers are deemed to be “firm” may lead to DN exit capacity charges reducing, however, as a greater number of end users contribute to the allowed revenue. The mechanism for recompensing customers who contract to provide interruption services is not defined and it is not clear where this expenditure would sit within overall DN expenditure. Clarification is required in particular as whether this expenditure would be defined as capex or opex – whilst it is easier to see it as opex it is replacing the need for capex. We therefore consider that interruption reform will need to be considered in part in relation to DN Charging Mechanism Structural Reform.

Question 13: Impact on small businesses - Ofgem's initial view is that proposed reform of the interruption arrangements on the GDNs will have no direct effect on small businesses as they will not currently nominate to be interruptible and are very unlikely to want or be able to be interruptible in the future, as only daily metered sites can be interruptible. Under the GDNs model they would not need to do anything as they would currently be firm customers and would remain firm customers. Ofgem welcomes views on the impact on small businesses, if any, of reform of interruption arrangements on the GDNs.

We agree that small businesses are unlikely to be affected

Question 14: Risks and unintended consequences - Ofgem has set out in Chapter 2 its concerns about the current arrangements for interruption on the GDNs. Chapter 1 also identifies previous consultations Ofgem has issued which identified significant weaknesses in the current arrangements. Ofgem's IA will build on this analysis to identify the risks of not changing the current arrangements. Ofgem would welcome respondents views on any risks or unintended consequences they believe would arise from reform of interruption arrangements on the GDNs, which are not identified in this consultation or the other questions for the IA

No further Comment.