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Dear Bob,

Response to TPCR Initial Proposals

The transmission price control review initial proposals, in addition to discussing issues affecting the revenues required to fund transmission activities, also includes a draft impact assessment of the proposed reform of the NTS exit arrangements. This response is on behalf of National Grid's distribution business and comments on these latter issues. In addition to answering the relevant questions in appendix 17 we have commented more generally below.

The draft impact assessment considers models based on the concept that flat and flow flex capacities are linked, with additional flow flex being available at times of low demand. However, the debate within the industry has now moved on and "expanding flow-flex" models are no longer being considered. We therefore believe that it is more constructive to make our comments on NTS exit reform more generally, rather than commenting in detail on the impact assessment of a model that is no longer being considered.

In our view the key issues for exit reform are:

- Efficiency of investment
- Providing users with non-discriminatory access (including level of NTS discretion)
- Customer Commitment
- Interaction with DN Interruption reform

Each of these issues is discussed below.

Efficiency of Investment

The primary objective of the NTS exit regime is to deliver the required network as efficiently as possible. We believe that the detailed design of the exit regime is crucial to achieving this, indeed a poorly designed regime will significantly **increase** the investment required within the system. This is illustrated by the following examples:

- Whilst the equipment on the distribution network is robust and properly maintained, inevitably a small residual risk of failure remains. If Flow-Flex is defined and enforced as a nodal product, all connected parties would be obliged to purchase sufficient Flow-Flex at each node to cover the worst case scenario of a failure at 2200 hrs. Hence the NTS would be faced with a massive increase in the level of Flow-Flex being requested by customers. Equally, the only way for the NTS to be certain of being able to meet all these requirements in full would be to

size the system to deliver them all simultaneously. It can be seen that a need for significant investment in the system has been created, but no additional load has been placed on it.

- Consider two NTS Offtakes that supply an isolated part of a DN network. As above, either Offtake could fail on peak (e.g. loss of odorant). Again, the use of a nodal product would require the DN to book full peak capacity at both offtakes to be sure of not exceeding the booking. To the NTS the level of demand being requested would appear to have doubled and investment could be triggered.

On the basis that the wider gas system has performed satisfactorily for many years, then any investment triggered purely by the introduction of a new exit regime is evidence of inefficiency in the new regime. The operation of any large system is based upon a probabilistic assessment of what might be expected to happen, for example the 1 in 20 and 1 in 50 criteria. The two scenarios above highlight the need for exit reform to allow for diversity: not all offtakes will trip simultaneously in first example and in the second example, whilst the load at one Offtake may double there is no increase in the total volume of gas taken off the system in the vicinity. The risk of a nodal model is that by identifying the worst event that could occur at each Offtake and then requiring a sufficient booking of flat and flow-flex capacity to cover this eventuality, we lose the savings that result from assuming a level of diversity, and an over-engineered system could be built. There are two ways of allowing for diversity within the regime:

- Build it into the product definition. For gas demand fed by the Distribution Networks, the sites where the gas is consumed are effectively fixed: factories, homes and offices. Accordingly, a failure at one Offtake will result in the gas being taken at another nearby Offtake (assuming there has been no loss of supply). Thus the change seen by the NTS is local with no impact on the wider flow patterns. Accordingly, we support the recent proposal to use zones for measuring performance against exit bookings. In this way, the swapping of gas between adjacent offtakes caused by operational events will not be an issue so long as the changes are within the same zone.
- The NTS could explicitly make an allowance for diversity. Directly connected loads are different from DN offtakes in that following a trip the gas consumption will either cease altogether or, in the case of a gas fired power station, may reappear in a completely different part of the network. However, a level of diversity exists and not all loads will trip at the same time requiring the Flow-Flex simultaneously.

We believe that by managing diversity in this way, the current security of the system can be retained without triggering additional investment in the network. We also note that in the latest Ofgem proposal flow-flex will be monitored via the day-ahead OPN submission. We support this as a way of decoupling apparent flow-flex utilisation from demand forecast changes: under previous proposals a change in the weather forecast leading to a reduced demand forecast would have increased apparent flow-flex consumption and potentially exposed the DN to over-running its booking.

In summary, we think that the latest proposals at the Enduring Offtake Working Group for the transitional regime to be monitored using zones are a big step forward and should be used as the starting point for designing the enduring regime.

Providing Non-Discriminatory Access to the Network

Ofgem are understandably concerned that there should not be discrimination between users of the gas network. To date, this concern has focussed mainly upon the current differences between access arrangements to the NTS for DNs and other users. Viewed from the perspective of a prospective or existing customer, it is more important to ensure that there is no distortion between the terms available to NTS connectees from those available customers connected to the DN. For example, if power stations connected to the NTS are obliged to purchase flow-flex, whilst DN connected stations do not, there will be an incentive for generators both to connect new stations to DNs and also to reduce output

overnight preferentially on DN connected plant, keeping transmission connected plant at full load. We therefore support moving the focus on discrimination to ensure that there is equivalence in the treatment of DN and NTS connected plant to ensure that investment and operational decisions are not distorted.

Another aspect of discrimination is the possibility of the NTS favouring the DNs within the National Grid Group over those that have been sold. Whilst we agree that the arrangements must give all parties confidence that this is not happening, we are not convinced that selling capacity via auctions will make a significant contribution. In reality, there will be few zones where there is competition for incremental capacity between users. Hence, the bulk of auctions will clear at the reserve prices set by the NTS. Accordingly, it will be the pricing methodology used by the NTS, rather than the auction process per se, that will underpin the fairness of the process. Given that the key issue in non-discrimination between the retained and sold networks is the pricing methodology (which can be altered without affecting the exit regime), discrimination provides only a weak argument for moving beyond the current arrangements in the transitional exit regime.

A similar argument applies to the reduction in the number of ARCA disputes. The disputes do not result from the existence of the ARCA, but rather the associated prices and conditions. Moving to a system with auctions being cleared at reserve prices will have similar scope for disputes regarding prices and other conditions.

Hence, we do not see a compelling case for further reform beyond the transitional arrangements based upon efficiency of investment.

User Commitment

As explained in our previous consultation responses, we have the following concerns with user commitment:

- User commitment is only appropriate to very large consumers whose individual decisions have a significant impact on the gas infrastructure. Most growth results from either the connection of additional smaller loads, or general load growth amongst existing smaller users. We estimate that of the demand supplied by DNs, only around 10% of User commitment to increased capacity will actually be borne by large Users, the remaining 90% will be borne by the DNs.
- As we have noted previously, even where DNs are able to link additional capacity to an end user via an ARCA, there is still a residual risk. For example, a DN reserves capacity on behalf of factory A who signs an ARCA. In the event factory A takes the additional demand but factory B closes negating the need for the additional NTS exit capacity. The DN is committed to the capacity, but cannot pass on the costs.

In our view it is appropriate to require a longer commitment where the additional capacity will trigger investment. The shorter commitment would then apply to either maintaining an existing capacity booking or increasing a booking, but only to use existing capacity. This reflects the fact that there is no new risk to the NTS associated with allocating existing capacity as the costs are already sunk. We are concerned that under the proposals contained in the third TPCR consultation, a party that reduced its capacity could only return to its previous level of prevailing capacity rights by entering into a longer commitment regardless of whether investment is actually required. Such a regime will encourage parties to hoard capacity rather than releasing it for other participants to use. Furthermore, a user seeking to delay closure (possibly a power station in response to a perceived shortage of generation) could only do so by entering into a longer term commitment or relying on access to shorter term constrained capacity, regardless of whether any investment was required. It is conceivable that this commitment could lead to the closure of a large user that would otherwise be economically viable – even though the required exit capacity existed and no other parties were interested in using it.

When the detailed rules are drafted, it will be important to check whether they can be “gamed”. For example, it would be undesirable for a company to be able to limit its commitments by booking capacity in alternate years.

Interaction between NTS Exit Reform and DN Interruption Reform

Whilst the subjects of NTS exit reform and DN interruption are linked, they are separate topics and should be treated as such. The main driver behind DN Interruption reform is the concern that some parties are being given a discount for offering interruption, when in reality there is a very low risk of the interruption being required. If some parties are being given a discount whilst continuing to enjoy exit rights that are effectively firm, this implies a cross subsidy from those parties paying for firm access rights. This issue is quite separate from NTS exit reform and can be tackled without altering the NTS exit regime, as is illustrated by the fact that the UNC modification to implement DN interruption reform has been raised against the existing NTS exit regime. Indeed this point is brought out by Ofgem in the GDPCR second consultation paragraph 4.30 that recognises that DN interruption is primarily concerned with trade offs between interruption and investment within the DN rather than interruption and NTS Offtake Capacity.

The interaction between reform of interruption and NTS exit results from the DN's ability to optimise between purchasing additional NTS exit rights to meet peak demand or entering into further interruption contracts to manage peak demand down to the level of NTS exit capacity held. Whilst DN interruption reform is required for this optimisation to take place, there is no need to move beyond the transitional exit regime which provides DNs with cost signals for the value of incremental exit capacity. Accordingly, we do not believe that DN interruption reform strengthens the case for further development of the NTS exit beyond the transitional regime.

Conclusions

We support the latest proposals for the transitional regime as pragmatic and workable. In particular they address our concerns that the use of a nodal product may lead to inefficient investment by failing to take account of the diversity within the demands placed upon the system. Indeed, we are not yet convinced of the case for further reform beyond these transitional arrangements. We look forward to working with Ofgem to identify whether there are significant shortfalls in these transitional arrangements and, if so, developing the enduring regime.

If you wish to discuss any of these comments any further, please do not hesitate to contact me.

Yours sincerely

By Email

Phil Lawton
Distribution Regulation Manager

Responses to Ofgem's Questions in Appendix 17 of the TPCR Initial Proposals Consultation

A17.1 – What are your views on the benefits analysis conducted? The consultation identifies benefits in three areas, efficient NTS investment signals, Non-discriminatory allocation of capacity products and reduced incidence of ARCA disputes. These are each considered in turn:

Efficient NTS investment signals: It is our view that these benefits depend crucially upon the detail of the proposed reform. In particular, if the rules fail to recognise the importance of diversity in aggregating from nodal requirements to zonal or zonal to national, then additional investment will be triggered and there will be a net cost in this area. (The covering letter contains examples of both how this could happen and how the rules could be designed to avoid the problem.) Accordingly, we believe that the rules are insufficiently developed to form a view on the likely level of savings that will result.

Non-discriminatory allocation of capacity products: We see this topic having two separate strands. The first is ensuring that there is no systematic bias in the regime in favour of customers choosing to connect to either the NTS or a DN, so that customers have an incentive to choose the connection with lowest overall cost. We are concerned that if NTS connected customers are required to purchase flow-flex, but DN customers are not, this may distort the decision. We therefore maintain that the focus of the non-discrimination debate should move from comparing the terms applying to DNs with other NTS customers to ensuring that NTS and DN connected customers face equivalent conditions. The second strand is demonstrating that NTS treats all DNs on a fair basis. The savings forecast in this area result from increased transparency. As described in the covering letter, few of the proposed exit capacity auctions will involve competing bids for incremental capacity and therefore will settle at the reserve prices posted by the NTS. Hence, transparency will result more from the NTS pricing methodology than the introduction of auctions. On this basis, whilst we can see merit in reviewing the NTS exit pricing methodology, we are not convinced that introducing auctions will contribute significantly to reducing the risk of discrimination.

Reduced incidence of ARCA disputes: An ARCA dispute relates to the prices or other conditions contained within the ARCA. As discussed above, the prices under enduring exit reform will still be determined, in the main, by the NTS exit charging methodology. Hence the key to reducing the cost of disputes lies in the adoption of a fair and transparent charging methodology, rather than moving away from the use of ARCAs.

A17.2- What are your views of the cost analysis conducted?

We are not in a position to express a view on the costs faced by shippers. However, we believe further work is required to justify the exclusion of two points out of five as “outliers”. In terms of the gas transporter costs we note that Ofgem believes that quoted costs are conservatively high and we suggest that they should be revisited when the proposed reforms have been more clearly defined.

A17.3 – What are your views on our assessment of the potential environmental and social impact? We agree that the proposed reforms will have little impact upon either the environment or health and safety.

As described above there is the potential for a significant distributional effect if the reforms affect the decision of new customers as to whether to connect to the DN or the NTS and alter the charges faced by existing customers. For example, obliging NTS connected loads to purchase flow-flex would give a competitive advantage to DN connected generation.

In our view the effects of exit reform are unlikely to apply disproportionately to small businesses. Clearly, if a cost benefit is established, it can be expected that all gas customers will share in this benefit.

Finally, as described in question A17.1, there is risk of unintended consequences if the new arrangements do not allow for diversity when aggregating the demands that will be made on the system. This would manifest itself as additional investment to provide either incremental flat or flow-flex capacity.