RWE npower



Robert Hull Director, Transmission Office of Gas and Electricity Markets 9 Millbank London SW1P 3GE Your ref Our ref LOG219 Name Charles Ruffell Phone 01793 89 39 83 Fax 01793 89 29 81 E-Mail charles.ruffell@rwenpower.com

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# Transmission Price Control Review – Initial Proposals June 2006

Dear Robert,

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

Our non-confidential response to the questions raised in the consultation is included below. However, our response also includes an Appendix that is confidential and should not be published on the Ofgem website.

## **General Comments**

As a major user of both gas and electricity transmission networks, we agree with Ofgem that timely investment in these networks is essential to ensure their continued efficient operation. We strongly believe that the new price control framework should align the incentives between the providers of monopoly transmission capacity and infrastructure developers requiring connection to it. Where there is continued misalignment, then the risks need to be allocated correctly between the parties.

In principle, we can see merit in the approach proposed by Ofgem, with allowances set for a defined baseline network, together with drivers for load-related expenditure that increase or decrease revenues in response to signals for incremental investment. It is helpful that the transmission companies themselves have also broadly endorsed the approach. We recognise that there will be ongoing discussion around setting baselines as these will be key to triggering the incremental revenue drivers. In our view, baselines need to reflect system capability.

RWE npower
Trigonos
Windmill Hill
Business Park
Whitehill Way
Swindon
Wiltshire SN5
бРВ
_
T
+44(0)1793/8
9 39 83
F
+44(0)1793/8
9 29 81
I
www.rwenpowe
r.com
Registered
office:
DWE Moorrow als

However, moving away from fixed allowances to fund forecast levels of capex to one based on revenue drivers flexing in response to demand for additional capacity has implications for how users secure future network access. Users making financial commitments to back their requests for future access rights underpin the proposals. We still have an issue about what user commitment will mean in practice and whether it is practicable in all cases.

We share Ofgem's concern that capital expenditure should be efficient, timely and reduce the risk of asset stranding and that some degree of user commitment could inform investment decisions. However, we still believe that transmission companies should have a central role in network development, as they are the only ones able to take a network-wide view and operate under a number of licence and other statutory obligations. Some aspects of the initial proposals shift risk for the network operators and onto users. The arrangements should not allow the transmission licensees to abdicate management of the risks that they are best placed to manage.

For non-load related expenditure and operating expenditure, the document sets out what appear to be challenging targets when compared to the licensees' original submissions. As the consultant reports and other analyses that informed Ofgem's position are not available, it is difficult to offer detailed comment on whether these proposals are in any sense reasonable. However, as a general principle, we believe that the network businesses should be funded to an appropriate level given the key role played by the transmission networks in facilitating gas and electricity competition. As discussion between the licensees and Ofgem is confidential, it is a matter for Ofgem and its advisers to ensure that the industry can be satisfied with the rigour of the financial assessments and that the financial parameters are consistent with the possible future level of investment required to support changing patterns of supply and demand. For instance, we would be concerned at an outcome that resulted in NGG NTS reduced network flexibility by not replacing compressors, at a time when increased flexibility is required.

## St Fergus Costs

Although Ofgem is specifically consulting on its proposal to exclude £75m of load-related expenditure at St Fergus, there is insufficient information provided to make an informed view. If the investment was made to meet statutory or licence obligations then we believe it should not be disallowed. Going forward, the arrangements need to avoid this kind of uncertainty as it affects both National Grid Gas NTS (NGG NTS) and system users.

## **Gas Entry Incentives**

In our response to last year's Initial Thoughts consultation we argued that that Ofgem should undertake a fundamental review of the gas entry capacity arrangements and that this should be set as an objective of the TPCR. This has not been undertaken and it is therefore difficult to assess the impact on investment efficiency that the auction arrangements have had. The proposals to modify the gas entry capacity incentives could arguably be considered as attempts to fix perceived weaknesses in the current regime. The changes add additional complexity to already complicated arrangements. Worryingly, it appears that Ofgem now wishes to transpose these to gas offtake and the electricity market. Again, we would strongly urge Ofgem to assess the last five years of entry capacity auctions before pressing forward with wider ranging reforms.

#### Capacity Release Mechanism

We welcome Ofgem's proposals to retain baselines for gas entry capacity and for the obligation to release baseline to apply up to within day. This gives the regime transparency and stability and does not undermine existing capacity purchases made in earlier long-term auctions.

#### Capacity Substitution

The proposed entry capacity substitution mechanism to reallocate existing baseline capacity before undertaking incremental investment and triggering the revenue drivers should, in theory, improve efficiency. Although it potentially increases the availability of capacity at some ASEPs, it does increase the risks faced by shippers. To make an informed choice about what time frame to buy capacity, shippers will need to assess the risk that capacity may be reallocated, so the reallocation methodology needs to be unambiguous. As described in the document, presumably for reasons of simplicity, only "reasonably substitutable" ASEPs will be included in the mechanism, which introduces the potential for differential treatment. Network-wide substitution would require the use of exchange rates that would introduce considerable complexity, which we would not support.

At this stage of development, it is also unclear what incentives NGG NTS will face to substitute between ASEPs that have significantly different revenue drivers and whether there needs to be a mechanism to adjust allowances following reallocation. An additional complication would be how the methodology would deal with incremental additions to entry baselines that arise as a consequence of the interaction with exit-related investment. We would welcome further details in this area but we remain to be convinced that the proposed substitution mechanism that results in changes to baselines will be meaningful in practice. Optimisation over the constrained release period may be a better objective, which could be achieved with some amendment to National Grid Gas NTS' current incentives to optimise capacity release close to the day of delivery.

#### Incremental Revenue Driver

Given our reservations about the auctions held to date, we still see no compelling reasons to move away from an approach based upon licence and other statutory investment obligations allied with a centralised planning model. However, under a model of fixed baselines, conceptually, the revenue driver approach makes sense to address uncertainty over the required future level of load-related capex, but its design does raise some issues. One concern is that adopting an overly mechanistic approach, where investment is driven purely by user commitment, may not be consistent with the situation where the lumpy nature of investment results in efficient provision of capacity in excess of that requested. It raises the key question of how to size the capacity increments associated with the revenue drivers. Ofgem's analysis suggests that the level of the revenue driver is sensitive to the assumed increment size.

It is also proposed that auction reserve prices will be set separately from the nodal revenue drivers set out in the Licence, breaking the current linkage between the two. This means that there may be a divergence between actual and allowed revenue which will then need to be managed through the TO commodity charge. This will introduce volatility into the level of transportation prices year on year. Furthermore, the Gas Transmission Charging Methodology Forum has been considering potential changes to the model and methodology used to derive transportation prices. Initial modelling suggests that for some ASEPs there will be step changes between the prices derived from the new model and current prices. The decision whether or not to adopt a new model is subject to industry consultation but there is a clearly an interaction between the decision, setting of revenue drivers and the impact on prices going forward. 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 undermine shippers' confidence about making a long-term commitment.

#### **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 incremental network investment. The proposal for an administered buy-back price for buy-backs relating to the delivery of incremental capacity is an improvement on the current situation which effectively is simply the avoided daily capacity charge. We are still concerned that the administered price may not be an effective proxy for the market price in Y+3 to Y+8. Also, the true opportunity cost of the delayed capacity delivery to the shipper may be well in excess of the administered price. While the prospect of bi-lateral arrangements is envisaged, NGG NTS may be reluctant to enter into them.

#### **Gas Offtake Incentives**

## Transitional Period

Ofgem's initial proposals for the transitional period are largely unchanged from those contained in the third consultation, which we were broadly supportive of. In addition we note that Ofgem have provided further detail on how they intend to specify revenue drivers for incremental non-specific load related reinforcement and we support the proposal for a licence obligation to be placed on NGG NTS to report annually on such investments.

Whilst we can see some logic in revenue drivers being triggered upon the date NGG NTS has contracted to deliver that capacity rather than the date that it is physically delivered, we are not sure this is should be applied during the transitional period. Unlike the enduring period there is no opportunity for capacity buy back during the transitional period and exit capacity is regarded as a being a "physically" rather than a "financially" firm product. The generic DC/DN ARCA also gives NGG NTS significant scope for amending the delivery date of incremental capacity and it is not clear how the revenue allowance would applied in the event they exercised this option.

#### Enduring Period

#### Capacity Baselines

We continue to support the nodal allocation of flat capacity and assume that the enduring baselines will be based on the transitional baselines plus any firm incremental capacity that is booked/delivered during the transitional period. We welcome the fact that Ofgem is intending to included the five current interruptible sites in the south west quadrant within the enduring baselines based on their current SOQ's and the setting of a zonal revenue driver for this quadrant to remunerate any user commitment that is signalled.

We are disappointed that NGG NTS have decided fairly recently that they can not support a single expanding flex product and that as a consequence flat and flex capacity will now have to be treated as separate products. This will significantly increase operational and administrative complexity for shippers, DNOs, NGG NTS and Ofgem. Despite Ofgem's assertions that the net impact to customers of these new enduring arrangements will be positive, this latest development leads us to be even more sceptical of this claim than we previously have been.

A national flexibility baseline and zonal maxima set with an over-arching area maximum, as currently proposed, will be extremely difficult to manage and it is not difficult to conceive that this might lead to false investment signals, unequal access to flexibility across similar classes of user and unintended consequences (for example in the electricity market or in provision of demand side response).

Whilst we agree with the principle that entry capacity investment should result in increased exit capacity baselines (and possibly vice versa) it is not clear to us how this would be allocated between users and classes of user bearing in mind incremental capacity is expected to be triggered by user commitment, or how it may impact on exit (and possibly entry) capacity release

incentives. It is also not clear whether both flat and flex exit capacity baselines would be increased to take account of entry capacity investment and how it will be apportioned between the two products.

#### Capacity Allocation

We strongly believe that flat capacity should be allocated on a "prevailing rights" basis and recognise the need for a proportionate level of user commitment for incremental capacity required above this prevailing right. To the extent that enduring baselines will be set based on the maximum practical physical capacity that is available, we fail to see why the user commitment should apply to prevailing capacity other than for the fact that a period of notice should required in the event a user wishes to relinquish any prevailing capacity it holds. As discussions at EOWG have largely centred on flexibility of late we are unsure of Ofgem's current thinking on flat capacity release.

We also remain concerned that little thought has yet gone in to considering how the user commitment process can be aligned with the reality of the lead times and timescales relating to exit project development. Experiences at entry have shown that in a number of cases the timetable for entry capacity release has not fitted in with the realities of project timescales which has led NGG NTS to apply for time extensions and for scaling back of incremental release obligations. In the absence of any further alignment at exit there is a danger that exit development projects will also suffer inefficiencies and be delayed due to their inability to signal investment within a specified window. This may have knock on consequences for security of electricity (in the case of CCGTs) and gas (in the case of storage/interconnector sites) supplies.

Flex capacity release is currently subject to extensive discussion at EOWG. Despite proposals by the AEP to simplify this process and allow directly connected shippers, storage facilities and inter-connectors to passively manage their flexibility requirements we remain concerned that the method eventually proposed will represent the least worst option, which users will have to live with and adapt to its imperfections.

This is wholly unacceptable bearing in mind NGG NTS have presented evidence to suggest that the highest aggregate flexibility utilisation observed nationally on a single day was approximately 2/3<sup>rds</sup> of that which they are prepared to make nationally available on a physical firm basis. It is also less than half of that which might be expected to be available on an off peak day under one of their Ten Year statement supply scenarios.

Rather than continuing to try and develop a "one size fits all" release mechanism to force the allocation of a potentially scarce quantity of flex capacity (at most for a small number of days each year but possibly not at all) between DNOs and directly connected shippers, storage facilities and inter-connectors (all of whom are unlikely to know how much flex capacity they need much before the gas day) we would urge Ofgem and NGG NTS to look at whether existing system management tools can be adapted or strengthened to manage the rare occurrences when the system is likely to come under stress. NGG NTS/Ofgem should look again at the relevant provisions of the UNC<sup>1</sup> and the relevant shipper and transporter licence<sup>2</sup> conditions as in our opinion these obligations adequately address NGG NTS's concern about not being able to manage linepack depletion arising from unfettered use of flex capacity.

<sup>&</sup>lt;sup>1</sup> TPD I2.3 - 2.6 and OAD J4.5 - 4.6 and J7.2 -7.3

<sup>&</sup>lt;sup>2</sup> Shipper Licence Condition 3 and Transporter Standard Special Licence Condition A17

# **Capacity Release**

We agree that baseline and any non-obligated firm capacity should be released up to within the gas day itself and that interruptible capacity should be released in the event sold capacity is not fully utilised. An incentive to encourage NGG NTS to maximise capacity release would appear appropriate for flat capacity but we are not convinced this would be appropriate for flex capacity. Indeed NGG NTS's insistence that only 22mcm of physically firm capacity can be made available, when modelling and past experience suggests that there is likely to be significantly more than this available on the majority of days throughout the year, may be an attempt to secure a flex capacity incentive, and it would be wrong in our view to reward them in this way based on the evidence we have seen to date.

Pricing of long and short term firm and interruptible capacity will be important but it has not yet been discussed how this would be undertaken. In our view it would seem logical to ensure that exit capacity pricing arrangements are consistent with those prevailing at entry.

## **Revenue Drivers**

Ofgem's proposals on establishing revenue drivers do seem to strike an appropriate balance between precision and simplicity and we await further information on the zonal revenue drivers for small capacity increments that are being proposed.

We note that Ofgem will still intend to modify the licence to set revenue drivers in respect of unanticipated projects above a certain threshold. We assume this will be done after a user commitment has been given in the unconstrained period. More work needs to be done to understand exactly how such a commitment is given for a completely new offtake point and what ancillary contracts are needed either pre or post commitment to ensure capacity is made available in line with the eventual unconstrained timescale. This will be particularly important bearing in mind the likelihood of further CCGT build over during the enduring period.

## Substitution

Ofgem's reasons for proposing that an exit substitution licence obligation be placed on NGG NTS are vague and insufficient detail has been made available to allow us to gauge how effective or practical substitution may prove to be. Nor is it possible to understand how this might interact with zonal revenue drivers for small capacity increments and any non-obligated capacity release incentive.

As previously stated we believe that the instances where substitution will take place are likely to be rare and that it may also undermine the "prevailing rights" approach to capacity allocation and lend support to a "finite rights" approach. To this extent it is not clear what extra this will achieve bearing in mind NGG NTS already has a licence obligation to consider spare capacity in the locality before making incremental investment.

We had assumed that substitution could only take place between exit points. However, the first bullet point in paragraph 1.65 of Appendix 16 states that "if there is an offtake point where demand exceeds the baseline level of capacity and there is a "reasonably substitutable" entry or offtake point with unsold baseline capacity, then NGG NTS will develop a proposal to transfer capacity between the relevant points at an exchange rate to be calculated by NGG NTS". If this is indeed what is envisaged then substitution is likely to be even more of a black box to shippers and it will be impossible for them to predict the possible likelihood of baseline capacity being substituted away from an exit or entry point.

It is also not clear whether the substitution obligation would apply to flex capacity, and if so how this would tie in with NGG NTS's current proposals of allocating a national flex baseline subject to zonal and area maxima.

## Buybacks

We recognise the need for consistency in the treatment of buybacks relating to failure of NGG NTS to deliver investment on time across the entry and exit regimes. We do not believe however, that this necessitates consistent investment timescales, exposure caps or compensation arrangements and believe there is scope to adopt different buyback arrangements within individual bilaterally agreed incremental investment agreements.

## **Payment Flows**

No further detail has been made available about how GDNs will pass on NTS exit capacity charges (flat and flex) but we are assuming that a detailed breakdown of these (by DN Exit zone) will be included on any GDN invoice and that no new charging codes will be required.

We recognise that as a consequence of the option 2A model shippers will be required to put more security in place to cover the fact that NTS charges are recovered by the DN. This should logically result in an equal and opposite reduction in the security we are required to provide to NGG NTS. However, we are concerned that this may not be the case in practice due to the different RAV values of NGG NTS and the different GDNs. As a consequence shippers could face increased credit costs as a result of the new payment arrangements.

We have not been able to quantify these extra at this stage but would recommend that Ofgem consider this issue in more detail and factor any likely impacts into their final impact assessment.

#### Enduring Offtake Impact Assessment

We do not place much store in Ofgem's net benefit case at this stage bearing in mind it has been derived from an initial impact assessment and was conducted at a time when the details of the proposed enduring arrangements were not fully developed or understood. As mentioned in our response to the initial impact assessment we believe that the move away from the "single expanding capacity" product will lead to extra costs burdens on shippers (particularly SSMPs) as there is less scope for them to manage flexibility requirements passively.

The initial benefits case appears on the face of it to overstate the benefits in a number of areas, for example in non-discriminatory allocation of capacity and reduced incidence of ARCAs. The cost case is also impacted significantly by the exclusion of outliers, which at this stage of understanding is neither appropriate nor statistically defensible.

Whilst we recognise the difficulties inherent in producing impact assessments the industry is becoming increasingly sceptical that Ofgem use these to demonstrate net benefits which are just about large enough to justify the continuing to pursuit of market based offtake arrangements. Bearing in mind the UNC, licence and statutory obligations that already apply to NGG NTS, DNOs and shippers regarding offtake arrangements, and that no obvious instances of abuse of these obligations have been cited publicly or anecdotally by Ofgem or NGG NTS, we would hope that when Ofgem produce their final impact assessment they adopt a more rigorous approach to dealing with benefits which might arise but are hard to quantify, or inefficiencies that might be inherent in the existing system but are hard to spot.

## **Electricity Incentives**

We support the view that the drivers for local connection works and deeper reinforcement may be different, particularly given the 'lumpy' nature of wider transmission investments. It is therefore appropriate that the mechanisms are tailored to recognise these differences. In principle the mechanisms should be as simple as is possible whilst having reasonable correlation with costs.

We agree that on some occasions large investments may initially over provide capacity and an automatic revenue mechanism will be too low. In this case we would support the introduction of a 'revenue driver adjustment event' mechanism (RDAE) to allow transmission companies to apply for the relevant driver to be based on the additional capacity or a larger proportion of it, rather than by the additional capacity being demanded by users. If such a mechanism is put in place, the process should be similar to that used for Income Adjusting Events (IAEs) to ensure disclosure of information to the industry and full debate.

We support the principles of facilitating competition where this is possible. However we would be concerned if the proposal to open up large investments to extend the transmission network to competition resulted in either a delay to the investment timetables, resulted in a distortion to the existing charging methodologies or gave rise to perverse locational signals.

We are fortunate to benefit from a very reliable electricity transmission system throughout Great Britain. We have consistently argued that the present Network Reliability Schemes effectively reward the Transmission Owners for carrying out their licensed duties. We therefore support the proposal to introduce a 'penalties only' scheme with the caveat that penalties are only applicable for events clearly within the control of the Transmission Owners.

The driver for the introduction of the 'Innovation Funding Incentive' scheme within the most recent DPCR was the recognition that network owners were likely to face technical challenges during the period of the price control. The likely increase in generation connected directly to distribution networks was anticipated to trigger this change. In practice, little of this allowance has been used to date. It is not clear that transmission owners face a comparable challenge in the next five years. We therefore await Ofgem's further proposals with interest.

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