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Dear Lewis

Reform of interruption arrangements on gas distribution networks - an update

energywatch welcomes the opportunity to respond to the issues raised by this consultation document. This response is non-confidential and we are happy for it to be published on the Ofgem website.

We note that the consultation has been raised at the same time that gas distribution network (DN) operators have raised a modification to the UNC (UNC 090) which seeks to implement a reformed regime for interruptions on gas DNs. We have responded separately to the consultation on UNC 090.

We noted in that response that, while the interruptions regime does not impact on the majority of consumers (domestic and small business), there is a concern about how the reform of these arrangements could impact on those consumers through wider considerations relating to security of supply and the pricing of gas in tight supply/demand market conditions. We are also concerned about the interaction of an effective interruptions regime with the separate reform of gas offtake arrangements on the National Transmission System (NTS). As far as we can see, there has been no clarity regarding how the regimes may interact and the impact on security of supply and market prices.

In our previous response on reform of the gas DN interruptions regime (June 2006), we highlighted the expectations of all consumers that the gas DN operators and National Grid Gas (NGG), as operator and owner of the NTS, would deliver a secure, safe and reliable supply of gas at efficient and economic cost. This expectation must be matched through an appropriate interruptions regime on gas DNs which ensures that there are incentives on users providing interruption to do so by making optimal use of existing infrastructure, minimising the need for new investment and the potential for stranding assets, and helping gas DNOs and NGG to invest efficiently when and where necessary. We would also expect consumers to be provided with full transparency of the benefits of the savings from efficient investment and the way in which those benefits will be shared with consumers. These expectations remain in place under any reformed interruptions regime.

While we appreciate that the reform proposals presented in this consultation and through UNC 090 are intended to maximise flexibility to allow gas DNs to contract for interruptions on a locational and timely basis, we would question whether this approach addresses the level of interruptions likely to occur going forward and a consistent basis for determining the need for cost efficient and economic investment to respond to the interruptions sought across all gas DNs. There may be a locational element to the development of interruptions but the impact will apply across all the DNs. A fragmented regime may increase the potential for inefficiencies.

We now consider some of the specific issues raised in the consultation.

Draft Regulatory Impact Assessment (RIA)

As noted in our previous response in June, we support the production of a RIA but we do not consider it appropriate to draw conclusions from it until the completion of the process in early 2007 as it would be difficult to appropriately assess the costs and benefits on partial information alone. We note that the costs of implementing the proposed reforms are quite substantial, even based on Ofgem's more optimistic view, and relate mainly to putting in place systems and processes which are not currently used by DN operators when obtaining commitment from users to interruptibility. While we note the various quantitative and qualitative benefits of reform highlighted by Ofgem, all of which are admirable objectives and could provide real benefits to consumers, we are concerned that these lack specificity and may simply constitute aspirations which could in time be passed on to consumers.

We are unclear how these benefits will be shared with consumers. We asked Ofgem in our June response to set out how, in a transparent manner, the shared financial benefits of interruptions reform would be passed on to consumers. It is insufficient to argue that there will be clear incentives on gas DN operators and NGG to bring about efficient and economic investment from the market signals provided through the tendering of interruptions which also safeguards security of supply without specifying actual quantitative benefits.

Consumers need to be able to see actual and real cost efficiencies, calculated and then delivered back to them in a transparent manner. Gas DN operators and NGG are the parties who manage the networks on consumers' behalf. Therefore, the risks of managing the networks lie with them, with appropriate sharing of benefits also. We would not want to see a repeat of the situation which has arisen with the sale of some of the gas DNs when the promised benefits of the sales to consumers have not been visibly communicated and, indeed, additional costs of underinvestment have instead been passed onto them through the rolled over price controls. This is occurring at a time when consumers have already borne the full impact of multiple increases in retail prices. Ofgem must demonstrate clearly the real financial benefits if the significant costs of reform to interruptions are to be acceptable to consumers.

We note Ofgem's view that the reform proposals will improve security of supply for those users who may be able to provide interruption but whose actual interruption may cause real detriment. We are concerned that users such as NHS Trusts may be expected to provide interruption in circumstances where there is a substantive risk

of load shedding (a 1 in 20 winter). We believe that those users who ought to have priority status because their services are essential in terms of life and death should not have to interrupt and should have, at the least, an alternative means of securing energy supplies which does not require their supplies to be interrupted, whether the regime for interruptions is incentivised for increased efficiency and security or not.

In summary, we recognise that Ofgem has highlighted a number of potential qualitative benefits if the reform of interruption arrangements takes place. We do not dismiss lightly the potential for improvements to security of supply, increased flexibility of interruption services and possible reduced costs and more efficient investment in networks by gas DN operators. However, there needs to be an appropriate balance between introducing interruption arrangements which allow some flexibility and innovation in the provision of interruptions products, and the potential for inherent complexity which reduces overall transparency of how costs have been arrived at. We see little firm evidence that there will be financial benefits to consumers, how these will be clearly shared and how those will be communicated to consumers in future price controls or otherwise.

Incentivisation

We welcome the possible benefit that reform of interruption arrangements could bring if there was greater transparency, and availability, of information about how each of the gas DN operators applies the reforms within their areas. This could allow effective benchmarking of application and understanding of how to develop best practice. However, we also believe that there is an integrated nature to the gas DNs which means that the possible locational use of interruptions could create disconnects between the networks which lead to inefficient investment. We have similar concerns regarding how the gas DNs would apply the interruptions regime with regard to offtake arrangements from the NTS.

In our June response, we supported the development of incentives for gas DNs in purchasing requirements for interruption which would encourage efficient expenditure on new infrastructure, better use of existing infrastructure and minimisation of stranded assets. We also supported the use of incentives embedded in the price controls in the context that there would be consistency between the overall approach to determining price control allowed revenue and the relatively small amount of further incentives required for efficient purchase of interruptions.

We maintain that this represents a responsible approach, although we note the alternative options for setting incentives including use of a sliding scale approach outside of the price controls. Our reasoning requires that any incentive scheme should be relatively simple to understand, not unduly complex so that appropriate savings accrue for consumers' benefit, and that there is a transparent approach to deriving the incentive. We believe that using the price control may provide such an approach. However, Ofgem must show greater commitment to obtaining cost information from the gas DN operators and publication of the costs to determine the appropriate level of efficiency.

This equally applies to the purchase of offtakes from the NTS by gas DN operators. The most efficient outcome requires gas DN operators to purchase only offtakes which are operationally efficient and meet demand taking into account the ability to interrupt in a way that does not adversely impact security of supply. This will require appropriate long-term planning and effective interface between NGG and the gas DN operators. The separation of ownership of some gas DNs should not create discriminatory treatment in terms of the information flows from NGG or hamper effective planning in this respect and we would ask Ofgem to keep this area under scrutiny.

We recognise that locational constraints can and do occur and that these could impact on the efficient purchase interruptions as well as the appropriate incentives on gas DN operators to provide a suitable level of infrastructure. However, we are concerned that a significantly costly reform of interruptions may not necessarily provide the investment signals that Ofgem hopes will arise. Users may not be inclined to bid for interruption services and be happy to offer firm commitment to interrupt only on a short-term basis. If that is the case, there is a real risk that locational constraints may continue and that efficient investment in infrastructure will not occur. We would question whether there is the appetite among large users, particularly large consumers who may wish to offer interruption, to make longer-term commitments or to bid into the tender process proposed by the reforms.

In conclusion, we have doubts about the efficacy of the reform of interruption arrangements and whether there will be an overall and tangible benefit in which consumers can share without more specific information than is provided in the consultation. We are also concerned that costs will be expended but users who wish to interrupt may not necessarily provide more effective signals to gas DNs about future investment, thereby negating the efficiency and economy of the reforms without improving security or safety of supply.

Going forward, we will continue to keep these issues under review as and when they are raised, particularly in connection with future enduring gas DN price controls, always considering the possible impact on consumers.

We would appreciate being kept informed of the progress of the consultation and any related issues to enable us to comment as the need arises.

If you do wish to discuss our response further please do not hesitate to contact me on 0191 2212072.

Yours sincerely

Carole Pitkeathley
Head of Regulatory Affairs