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Lewis Hodgart
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Dear Lewis

Reform of interruption arrangements on gas distribution networks – An update

Northern Gas Networks welcomes the opportunity to comment on this consultation which it understands will be followed by a further consultation and impact assessment in the early months of 2007. We found it valuable to meet with you last month to explain the background to the current interruption regime and to our designation of network sensitive loads (NSLs).

Our response is built on that submitted to Ofgem in the summer of 2006, and takes into account the development of Modification 0090 Revised DN Interruption Arrangements in recent months.

Of particular concern is the market power of NSLs which may lead to substantive costs of providing interruptible rights. These costs are impossible to predict.

A principle objective of interruption reform is to provide appropriate long term incentives to enable optimal investment decisions to be made. NGN agrees that it is not possible to set long-term incentives given the uncertainty of the impact of interruption reform. However it should be recognised that the impact of a one year incentive is likely to result in sub-optimal short term decisions, for example paying a high price for interruptions rather than investing in the network.

It should also be noted that the HSE has expressed concern to networks about the consequences of implementing interruption reform. Any changes to our ability to control the Network in an emergency will have to be risk assessed. The outcome of this risk assessment may require a change to our Safety Case which will have to be approved by the HSE. Our cost assessment does not include any costs related to changing our safety case. We will have to assess the final interruption arrangements against the present position. The worst case is that we have insufficient interruption capacity and have to move straight to firm interruption.

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

Yours sincerely

Alex Wiseman
Regulation Director

Chapter 3. GDN incentives

Question 1. Which of the options proposed by Ofgem for setting a one year incentive for the GDNs purchases of interruption and NTS offtake capacity do respondents support and why?

NGN continues to have substantive concerns about the market power of NSLs. It is not possible to predict the likely cost of providing required interruptible sites with interruption rights and, furthermore we do not know if these sites will even bid. The behaviour of Users is outside the control of GDNs. This is particularly the case given that the pricing proposals within Modification 0090 "Revised DN Interruption Arrangements" are being promoted on an open tender basis.

Consequently, we would want to minimise the risk to NGN and option 3 is the lowest risk option. Hence NGN's preference is for option 3 with the incentive initially set very low to avoid any sizeable benefits or costs which could not be readily anticipated or mitigated by DN behaviour.

Question 2. What are respondents views on the factors that should determine the level at which the interruptions and NTS exit capacity incentives are set?

As mentioned above, the incentive levels should be set at a low level initially. There are three key elements to consider when determining the level at which incentives should be set.

(a) Confidence level in assessing industry behaviour.

One of the central themes of both interruption and NTS exit capacity has been the extent to which GDNs have been unable to confidently predict the behaviour of Users. This level of uncertainty suggests that the proportion of any incentive gained or lost should be restricted to take account of risks that cannot be adequately assessed.

(b) Locational market power

The open tender pricing arrangements provide for a level of unknown risk from bids by Users with Network Sensitive Loads (NSLs). GDNs could theoretically be exposed to very expensive interruptible contracts or alternatively be obliged to re-enforce their network at considerable cost.

(c) NTS exit capacity incentives – baselines

Within the proposals for Modification proposal 0116VD, NGN has offered its support for the principle of exit capacity baselines being published and agreed by GDNs before they are officially sanctioned as the baseline. If the incentive regime takes baselines into account then the figures used should be the finally agreed baselines and not those initially proposed by NTS.

Question 3. Do respondents agree with Ofgem's proposal to set a one year incentive for GDNs purchases of interruption and NTS offtake capacity from October 2010 and longer term incentives as part of the GDPCR?

It is not viable to set incentives for any length of time as there is substantial uncertainty on the likely costs of interruption and hence a one year incentive is appropriate. However, a one year incentive scheme (October 2010 – September 2011) is likely to lead to non-optimal behaviours. Decisions made by GDNs in this area should not be short term decisions and the absence of any certainty of the October 2011 onwards incentive scheme could lead to some decisions which are not necessarily in the long-term interests of consumers. For example, it may be more economical for a GDN to pay a User its tendered interruptible contract price for one year rather than to invest in reinforcing its network (which may be a more appropriate decision on a five year view). A GDN will require the surety that capital expenditure incurred within a single year incentive will be recovered in future years. Without this certainty investment decisions may be deferred until an appropriate longer term incentive scheme is in place.

It is still too early to set longer term incentives as part of GDPCR until there is much more certainty about how the interruption regime will work in practice so that an appropriate cost target can be identified.

During the transitional period (through to 2010) it would be appropriate to roll forwards the existing interruption incentive for the GDNs.

Chapter 4. Draft Impact Assessment

Question 1. Do interested parties agree with the estimate of the costs of implementing GDN interruptions reform? Interested parties are requested to provide information about any costs they expect to incur to implement interruptions reform.

It should be noted that there may be substantive costs of providing interruption rights to customers that are currently NSLs or TNIs and these need to be taken into account in any impact assessment.

Details of NGN's estimated costs are provided in a separate, confidential appendix.

Question 2. Do interested parties agree that Ofgem has identified the appropriate benefits of the GDN interruption arrangements?

The categories of benefit appear appropriate but NGN has concerns about the methodology used to quantify the investment efficiencies and it is not clear that these benefits will actually be realised. Investment is largely undertaken to meet demand growth and most if not all of this will continue to be required after interruption reform. There needs to be further clarity on the basis for the efficiency factors that Ofgem has used.

Question 3. Do interested parties agree with Ofgem's estimate of the range of potential quantitative benefits of GDN interruptions reform?

Without commenting on the values within the potential quantitative benefits, NGN believes the rationale behind the baselines (appendix 2, paragraph 1.40) to be a fair basis on which benefits may be assessed. New connections and PRS investments may be similarly included in any such assessment.

Chapter 5. Developments to the structure of gas distribution charges

Question 1. Do interested parties have any views about the timing of the introduction of the introduction of the new arrangements for the customer charge?

Normally charges are changed in October and moving to new arrangements in October may result in fluctuations in charges for a number of years. About two-thirds of the revenue generated by the commodity charge is between October and April. Replacing this with a capacity charge in October would require a charge higher than required for a full year as it will need to generate two-thirds of a year's income in 6 months. It would then have to be reduced the following October as approximately two-thirds of that year's income will have been generated in the first six months. Changes in the level of capacity charge would continue to oscillate for several years.

Consequently, it may be more appropriate to move to capacity charges in April rather than October to avoid this annual price fluctuation.

Furthermore, it is worth noting that in 2007/08 allowed revenue will not vary with throughput. This means that if the proposed change is not implemented for 2007/08 collected and allowed revenue may differ by more than usually expected. This is because allowed revenue will not vary with throughput and collected revenue will remain 65% sensitive to throughput. This may result in large price adjustments required if expected and actual throughput are substantially different.

Question 2. Do the benefits outweigh the costs associated with changing the timing of changes to gas distribution charges from October to April each year to align with changes in allowed revenue?

The October price change date enables GDNs to take into account the effect of actual demand in the first half of the year when targeting Allowed Revenue. Recent weather trends have highlighted how difficult it is to predict future volumes, and a price change within the formula year enables GDNs to achieve actual revenue closer to allowed revenue. GDNs have a best endeavours obligation within their licences to set charges so as not to exceed allowed revenue. Consequently it is essential that GDNs retain the ability to adjust prices in October.

However, it should be noted that if a substantive price change is required in October due to over or under estimates the previous year then it is likely that this would lead to a corresponding under of over recovery in the following formula year; consequently, there is likely to be a reversal of this price change. An option to reduce these price fluctuations is to allow GDNs to change prices in both April and October.