Lewis Hodgart
Regulatory Analyst
Gas Distribution Policy Team
Office of Gas and Electricity Markets
9 Millbank
London
SW1P 3GE

Scotia Gas Networks
c/o Inveralmond House
200 Dunkeld Road
Perth
PH1 3AQ

Telephone: 01738 456400
Facsimile: 01738 456415
email:

Our Reference:
Your Reference:

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Dear Lewis

Reform of interruption arrangements on gas distribution networks – An update

We are writing in response to Ofgem's update paper on the reform of interruption arrangements on Gas Distribution Networks (GDNs). In doing so, we have provided our views on Ofgem's proposed one year incentive scheme including how Network Sensitive Loads (NSLs) should be treated going forward. We have then commented on Ofgem's draft impact assessment providing updated cost information in the enclosed confidential cost summary document. Finally, we comment on the two timing issues associated with making changes to the GDNs' charges.

1. <u>GDN Incentives</u>

In accordance with our licence obligation, over recent months we have worked with the other GDNs and the shipping community to develop Uniform Network Code (UNC) Modification Proposal 0090 (Mod 0090). We believe that if DN interruption reform is to be progressed, Mod 0090 would best meet Ofgem's objectives for reform and would address the perceived weaknesses of the existing DN interruption arrangements. However, as we have discussed recently, we are concerned that there are a number of outstanding issues that also need to be considered as well as Mod 0090, including pricing and price control/incentive arrangements.

Given the above, we very much welcome the publication of this consultation paper which provides details of Ofgem's thinking to date on the NTS offtake capacity and DN interruption incentive mechanism under the enduring arrangements. As we have stated in previous correspondence and discussions, this aspect of the reform is key since it will prescribe how the GDNs will recover the cost of the interruption contracts and the cost of NTS offtake capacity under the price control agreement.

We have considered the questions Ofgem as asked on their initial thoughts below.

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

We recognise the rationale behind Ofgem's view that an incentive should be placed upon GDNs under the enduring exit and interruption arrangements. However, we are concerned that the interactions between the component parts of the enduring regime are very complex and to date relatively un-modelled due to the planning regime to which the GDNs, and indeed the NTS, have hitherto operated. Therefore, to avoid the potential for unintended consequences and to allow the reforms to be implemented and "bed in", we believe that it would be appropriate to consider introducing a robust reporting framework in the first instance, based upon the finalised incentive approach, with financial parameters being applied at the beginning of the next price control period.

A similar approach was adopted when introducing the IIP scheme into the electricity Distribution Network Operator's (DNO) licence. The advantage of doing so was that it allowed Ofgem to collect valuable and comparable information from each DNO to ensure that appropriate targets could be set. At the same time, it ensured that the DNOs had an incentive-type framework within which to operate and report against knowing that Ofgem would be in a position to question and scrutinise the information provided.

Given the uncertainties of the new regime and since the incentive would only apply for the period October 2010 to March 2013, we believe that there is considerable merit in seeking to adopt a similarly phased approach. At the very least, this approach could be adopted for the first year of the incentive, i.e. 2010/11. The added advantage of this would be that it would help alleviate any timetabling issues associated with implementing Mod 0090 and the introduct of new price control arrangements and incentives with defined financial targets in the next few months.

Notwithstanding the above, we very much welcome the inclusion of Ofgem's option 3. We firmly believe that this is the most appropriate framework for the proposed one year incentive given the uncertainties surrounding the new regime. At this time it is very uncertain what costs the GDNs will incur in terms of interruption contracts and NTS exit capacity and, therefore, we believe option 3 goes some way to mitigating these.

Our understanding of the option 3 approach would be to create a "basket" of incentive targets each of which would have a predefined penalty/reward. In addition, there would be an aggregate penalty/reward that would, in effect, put a cap/collar on the overall exposure to the incentive scheme which would also be predetermined. The <u>actual</u> costs associated with each element would be fully recovered through allowed revenue. Under this framework, we believe the relevant components to the incentive would be interruption and both flat and flexibility capacity.

Certainly, we do not support either option 1 or 2 since they would both expose the GDNs to unacceptable levels of risk. While options 1 and 3 both involve setting targets for each incentive component part, we believe that option 1 has the potential to expose the GDN to far greater financial penalties than option 3. This would be inappropriate given the nature and extent of the reformed arrangements. Indeed, option 1 builds upon the exiting interim and transition offtake incentive under which we have already been exposed to costs ouside of our control. We have written to Ofgem previously setting out our concerns with the existing incentive arrangements and have summarised these points below.

1. **Genuine demand growth.**

   The targets have been set based on forecast demands. However, demand forecasting is not an exact science and there is, therefore, every likelihood that actual demand will vary when compared to forecast volumes at any particular node and in aggregate. In addition, small deviations from the underlying demand forecasts could have significant (and disproportionate) implications for capacity or interruption requirements (since investment is "lumpy"). Furthermore, currently a penalty resulting from a forecast deviation in one year is not restricted to that year, it rolls into subsequent years' assessment meaning that the DN potentially faces multiple penalties for the same demand forecast variation.

2. **Changes to Calorific Values (CV).**

   It is also important to note that a variation in the pressure and CV of the gas entering the DN can have an impact on the network's offtake capacity requirements, particularly for flow flexibility capacity. Under the existing incentive arrangements, a DN is exposed to CV variation where it has an impact on its capacity bookings relative to the targets that have been set. Since the DN has no control over CV variation (which remains the preserve of the NTS), we do not believe that it is appropriate that it is penalised for changes in offtake capacity requirements where actual CVs have varied from those used when setting the target parameters.

3. **No assessment of efficiency**.

   The incentive scheme is based upon the broad assumption that any request for offtake capacity or interruption contracts over and above the target quantities is "inappropriate". As we have indicated above, we do not believe that it is appropriate to penalise a DN where there has been genuine demand growth over and above that anticipated in the forecast, for whatever reason. We also fail to see why a DN should be penalised if it requests additional NTS offtake capacity or interruption in situations where this is the most efficient action to take, especially if the offtake capacity request can be accommodated by the NTS with no additional cost.

4. **NTS exit capacity charges.**

The reward/penalty associated with the existing offtake incentive scheme is calculated using the relevant, prevailing NTS exit capacity charge, which varies considerably between charging zones. In other words, a DN's incentive risk is materially dependent upon the NTS charging methodology over which it has no control.

We believe a one-year incentive based on option 3 could address these issues up-front.

For completeness, we do not support option 2 that would set an allowance within the RPI-X framework. Ofgem has explained that in it would be the strongest incentive of the three options however, in our view it would give us unlimited exposure to many aspects of the regime over which we have no direct control and therefore would be unacceptable. We also do not believe that the usual price control process will be capable of catching, up front, the complex interactions between offtake, interruption and investment. That is, we believe that it would be very difficult to set allowances for offtake, interruption and investment (with the latter also, presumably subject to a capex roller mechanism) without distorting management decisions. Certainly, if this option were to be considered the costs of interruption and offtake capacity would need to be treated as though they were in the regulatory asset base and therefore subject to the same rate of return as capital expenditure.

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

There are many factors that should be considered when determining the level at which the interruptions and NTS exit capacity incentive targets should be set. Ofgem has identified some of these already, such as historical information on the existing interruptible contracts; 1:20 forecast demand; the treatment of locational specific interruptible sites; and the likely weighted average price paid for interruptible capacity. However, we think that other, perhaps less obvious or easily measured things, would also need to be considered. For example, the willingness and/or ability of the shipper/customer to enter into new interruptible contracts; the historical approach to planning and the importance of the existing interruptible loads in that process. The "test" or methodology that will be used by the GDNs to determine whether or which contracts for interruption are taken will also be key to the setting of targets and would, we assume, be approved by Ofgem.

However, if targets are to be set for more than one year at a time, consideration will also need to be given to how a GDN's actual performance is influenced by things outside its direct control. For example, these would include changes in the calorific value of gas entering the network from the NTS; genuine unforeseen demand growth that the GDN has a duty to accommodate on the network; pressure variations caused by the NTS; and late delivery of offtake capacity by the NTS. Each of which will have an impact on one or more of the proposed interruption and offtake capacity targets. We believe that the targets should adjust automatically to changes in these parameters.

Ofgem has also asked whether the GDNs should be exposed to the cost of flat capacity at the time of purchase or at the time of use. It is clearly essential that the costs the GDNs would be exposed should be known at the time of purchase, indeed this is a fundemental building block of the proposed enduring arrangements if the GDNs are to be in a position to assess the alternatives that are available to them. We therefore believe that the GDNs should be exposed to the cost of flat capacity at the time of purchase. This would also mean that the target for interruption should be the total cost of both the option and exercise fee. This would also encourage the GDN's to optimise their choice in the structure of interruption contracts they accept. We do not believe the incentive should take account of the profile of capacity bought (that is whether it is bought in the long or short term). It would be in the GDN's interest to ensure that the most efficient option is taken and as long as there is evidence to support this decision we do not believe a profiled incentive is necessary.

From the above discussion it is apparent that there are many factors and uncertainties to consider when setting the incentives for the enduring offtake and interruption regime. In our view, this further supports an option 3 approach.

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

Yes, for the reasons Ofgem has described we support the proposal to set a one year incentive in the first instance to apply from October 2010. It will be important for the price control arrangements to be in place ahead of contracting for interruption and making NTS exit capacity requests for 2010 next summer, should both reforms go ahead as envisaged by Ofgem. Given the time available, we do not believe it would be practicable at this stage to endeavour to introduce an incentive for a longer duration.

We recognise that, ideally, incentives should be set for a longer duration than one year and, depending on the model adopted, it is for consideration whether it may be appropriate to apply the same model to the remaining years of the next price control period. However, at this stage we believe there would be issues with setting targets for more than one year at a time even under a longer-term incentive arrangement. This is because of the complex interactions of the component parts of the incentive schemes and the potential for significant shifts to occur in what is deemed to be "efficient" depending on the costs of each option. For example, a significant change to the cost of NTS exit capacity charges could mean that what was deemed to have been an efficient decision at the time an incentive target was set a shift in charges would mean that it was no longer the case. It will therefore be important to consider this when the incentive is looked at as part of the GDPCR process.

Network Sensitive Loads

Although no specific questions have been asked on this issue, Ofgem has also considered the issue of Network Sensitive Loads (NSLs). In particular, the potential locational market power of the NSLs and how to deal with the potentially higher costs of interruption demanded by these sites and/or the additional costs of investment should these sites not wish to enter into interruption contracts.

We firmly agree that this is a critical issue that must be addressed under the proposed DN interruption reform. While we recognise Ofgem's ultimate recourse of action under the Competition Act, we believe that a far better course of action would be to address this as part of the reform to ensure that the new regime does not create the opportunity for an "abuse" to arise and to avoid the risk of unnecessarily increasing costs to customers. NSLs are a legitimate part of the existing planning regime and have been designated as such as a direct result of analysis that has shown that to connect these sites as firm would be uneconomical. This rationale therefore remains true and to ensure that this legacy planning policy does not result in additional costs to today's consumers, we believe that the existing NSLs should be excluded from the proposed interruption arrangements. That is, we believe that they should be treated as a legacy issue and, to avoid undue interruption or reinforcement costs, the GDNs should be able to continue to rely on these sites for interruption under the new arrangements.

However, Ofgem has explained that it would expect the GDNs to be incentivised to minimise the cost of interruption being offered by these sites by either contracting with other sites for interruption or by reinforcing the network. Ofgem has also stated that it would expect the costs of managing this trade off to be accommodated within the incentive proposal. Furthermore, Ofgem would not expect the use of the Economic Test for covering a proportion of the reinforcement costs to be an appropriate tool in this instance. We are not sure what Ofgem means by this last point. In addition, if a different model is used for the NSLs this could distort investment decisions.

We also note that Ofgem is considering potential options of how to manage these costs, one of which is to treat them as specific costs with for example, a 50:50 sharing between GDNs and customers. Again, we are not entirely sure what Ofgem means by this, however, we do <u>not</u> believe that the GDNs should be exposed to any additional cost risk associated with these sites than it would be exposed to in any other investment scenario ie we would not find it acceptable to be exposed to a share of any additional costs associated with these sites. The existing arrangements have allowed these sites to be designated as NSLs since the costs of reinforcing the network to accommodate them would be disproportionably high. If Ofgem is of the view that this arrangement is no longer appropriate, the cost of that conclusion should not be borne by the GDNs.

A further option that Ofgem is considering is to factor in NSL specific price levels in the overall incentive. While preferable to the proposed sharing of costs described above, we believe it would still result in potentially high and unnecessary costs being introduced by the reforms when compared to treating the NSLs as a legacy issue under the enduring regime.

Interruption incentives for the transitional period

Again, no specific questions have been asked on this aspect of Ofgem's update paper although Ofgem's initial view is to roll forward the existing interruption incentive for the GDNs for the transition period. We would agree with this approach, however, we do not believe that it would be appropriate to set the targets to zero. As Ofgem has identified, to do so would be to expose GDNs to an asymmetric incentive that would mean the GDNs would be exposed to downside risk only. We do not believe asymmetric incentives are appropriate and therefore, a zero target would be unacceptable. In our view it would be appropriate to roll forward the targets that have applied in the transition period.

In terms of the offtake transitional arrangements, we believe that Ofgem should revisit the current targets in light of observed shifts in parameters from the present (such as demand and CV).

Timetable

The indicative timetable provided in chapter six is very helpful and has raised a number of questions that we are progressing with Ofgem separately.

We also note that the methodology to determine the economic test that the GDNs will apply to assess whether to accept interruption contracts rather than invest in the network will be critical to the DN interruption arrangements both in terms of setting the incentive and in making an assessment of a GDN's subsequent investment requirements. As we have indicated previously, the BPQ submission to date has not included any investment decisions that might be as a result of introducing the new arrangements. Therefore it will be necessary to update our BPQ submissions as part of the GDPCR process next year to reflect any consequential investment that is required as a result of applying that economic test.

2. Draft Impact Assessment

Ofgem's draft impact assessment shows that the likely costs of introducing DN interruption reform are in the region of £15m - £19m and the projected benefits of between £20m - £786m. We agree with Ofgem that for a more complete impact assessment to be carried out, additional information is required from both customers and shippers, as well as updated information from the GDNs and xoserve. Accordingly, we have provided as a confidential annex to this response updated implementation costs to help inform the impact assessment and which also should be allowed when setting the 2008 price control.

We note that Ofgem's approach to assessing the costs of the reform has been limited to the implementation costs only. That is, as far as we can tell, potential additional costs of reinforcement and/or the costs of interruption have not been included. As Ofgem is aware from the reinforcement cost information we provided in advance of our recent meeting, we believe that there is a risk that costs could increase quite considerably if shippers and customers do not, or are unable to offer contracts for interruption at an acceptable price to the GDNs. That is, the introduction of the reform could trigger a change in behaviour by shippers/customers such that they subsequently wish to become firm connections. We believe a key determining factor of the likely behaviour will be the economic test that is adopted by the GDNs. We believe that all things being equal, the economic test should seek to minimise the need for extensive reinforcement of the network. That said, it is likely that some reinforcement will be required and therefore these requirements will need to be accounted for in the GDPCR.

As we have discussed above, the NSLs pose a particular issue for some GDNs that have a number located on their networks. Therefore, at the very least we believe the potential additional cost of the NSLs should be considered by Ofgem in the impact assessment, unless of course they are treated as a legacy issue and carved out of the new arrangements.

3. Developments to the structure of gas distribution charges

Ofgem has provided a useful summary of progress to date on the gas distribution charges following Ofgem's February 2006 conclusions paper. In addition, Ofgem is seeking views on two specific aspects of these charges. We have addressed each in turn below.

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

For the reasons described in paragraph 5.7 of Ofgem's update paper, i.e to avoid significant price variability, we continue to believe that it would be best to implement the new arrangements for the customer charge in April 2007, rather than October 2007 and are currently consulting with xoserve as to how this would be best achieved should Ofgem agree to the April date.

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

We agree that it is appropriate to look again at the GDN's licence restrictions on the timing and frequency of changes to charges.

While we clearly understand the potential benefits of synchronising the GDN's charging and formula year, we do not believe that the benefits of doing so outweigh the disadvantages. For a GDN to set charges in April, indicative charges would need to be given to Ofgem in around November, with notice of actual charges to shippers be given in February. However, as Ofgem has highlighted, it is evident that to meet these deadlines the GDNs would be providing indicative charges ahead of entering the winter period and then setting actual charges well before the winter period is over. In other words, actual data from the key period that influences charges for the following year would be excluded from their calculation. Therefore, there would be a significant risk that setting charges in April would be worse that setting them in October, assuming the current restriction on the frequency of charge changes were to remain. There is also a possible risk that a move to an April date could trigger consequential changes. For example, there could be a move by shippers to move their contract year from October to April which could trigger proposals to change other key timelines such as the demand estimation activities and the AQ review. Clearly, this would have significant cost implications.

We are also mindful that under the enduring NTS exit capacity arrangements a proportion of the GDNs charges will be influenced the outcome of the charges the GDN has to pay the NTS under the various auction rounds for NTS flat and flexibility capacity. Furthermore, it has been proposed by NGG NTS that the GDNs will be liable to pay NTS SO and TO commodity charges which historically have been quite variable.

In light of the above two discussions, we conclude that the GDNs should, at the very least, have the option of changing charges in April or in October. However, to reduce the risk of large step changes in charges from one year to the next, we believe it would be advantageous to give the GDNs the option of changing charges in both April <u>and</u> October. We also believe that indicative charges would be more meaningful if the 150 day notice period were reduced to three months. This would also be consistent with the notice period that is required for electricity distribution networks.

We hope that you will find the above comments on the incentive arrangements, impact assessment and charging discussions useful. If you would like to discuss any of the points we have made in more detail, please give me a call.

Yours sincerely

Rob McDonald
Director of Regulation