Reform of interruption arrangements on gas distribution networks - An update

GENERAL COMMENT

WWU has been an active participant in the development of the UNC Modification Proposal 0090 and the Distribution Charging Consultation Paper DNCP01

WWU recognises that Ofgem views incentives as a key part of the introduction of comparative regulation between Distribution Networks operators. However there is no clarity about pricing for either NTS exit products and DN interruption services, this undermines confidence in any assumptions made regarding targets and costs and does not allow WWU to make proper commercial judgements.

CHAPTER Three: 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?

General:
Our major concern for all options is the lack of relevant data to develop reasonable and realistic target costs which could have substantial impacts on WWU business.

WWU would not support Option 2 in its current form as it offers no protection to DNs if costs exceed any RPI – x based level. This option significantly increases the risk to DN operators. However if there were more certainty on costs, and they are directly within the control of GDNs, this option becomes more attractive. Whether WWU is able to support Option 1 or Option 3 would be dependant on the various targets, sharing factors and width of Caps and Collars.

The document acknowledges that there is little relevant market data for the setting of the parameters under either option 1 or 3 and thus WWU do not have the information necessary to be able to explicitly support either Option.

WWU would like to ensure in this first year, and indeed subsequent years, is that there is protection against efficiently incurred costs that would be above any incentive Target. We would like there to be a “Safety Net“ in place to ensure that DNs are not unfairly penalised should actual costs be significantly different to the finally agreed option for 20010/11 given the current lack of clarity. At this point in time, we can see no alternative other than to have a pass-through arrangement for the lowest cost of either the reinforcement required of the avoidance cost paid to the customer. Any alternative would place an unacceptable commercial risk on WWU.

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?

1. Exposure to DN - risk must be in line with DN cost of capital.
2. Learning curve - this is a new area for DNs and interruptions regime should reflect this.
3. The outcomes of the Interruptions auctions - there could be variable response by the shippers to this process and incentives may need to be amended following different outcomes.

4. NTS Charges to DNs and the relationship between DNs and NTS - the incentive regime and Allowed Revenue for DNs must take into account the financial commitments the DNs have with NTS.

Question 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?

At this point in time, given the paucity of information, we can not make any sensible commercial judgements. Until we have all the information necessary it would be imprudent to accept such an unknown risk. In relation to the one year incentive please see comments to Question 1 around our concerns. In addition to these concerns, setting a one year incentive could adversely impact the correct behaviour required over a longer term.

In relation to longer term incentives WWU understand the need for Ofgem to include incentives within GDN revenue streams and WWU welcomes the opportunity to gain the benefits of efficient behaviour. The major concern at the moment, within Exit and Interruptions, is that the base framework is in it's infancy for DNs with limited relevant actual costs / behaviours for the industry to truly understand the right long term incentives and behaviours. WWU's concern is that speedy implementation of incentives around new areas could drive wrong behaviours and be potentially very detrimental to DN businesses.

An alternative approach could be to let the new regime bed in for 1 to 2 years and then develop incentives. This would allow the incentives to be based on more relevant actual costs and behaviours where GDNs understand the commercial implications and the risks they are being asked to take on.

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CHAPTER Four: 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.

xoserve are submitting a response on the areas of system development that relate to the UK-Link systems.

The costs previously submitted to Ofgem are described below:
WWU have considered costs which are over and above any previously identified for enduring Offtake reform and which are also additional to the SOMSA replacement project. Areas where costs would be incurred have been identified as follows:

- Network Planning – identification of location, volume and duration of interruption required
- Commercial – assessment of tenders
- Pricing – transportation income adjustment
- Finance back office, expansion of Transportation Income and Credit Control team

- . System Operation – exercise of interruption ensuring contractual obligations met
- The systems developed for Interruption reform will take the form of a series of decision support/ financial modelling tools. The systems would be required firstly for the commercial analysis of any decision to accept a tender for interruption services from a Shipper, looking at cost of tender, cost of alternative provision of capacity, transportation charges and incentive cost. Secondly, there would need to be a system to assess the commercial impact of the operational decisions made within the System Operation function – this is outside of the scope of the current SOMSA replacement project. The development of these systems had been assessed at around £0.5M with around £50k per annum update and maintenance charges. It was also assessed that the additional on-going resources associated with the systems would be around 1.0 FTE. There is work currently on-going to develop the scope and cost of these systems. The DN cost and design will be impacted by the outcome of the xoserve design for the core systems.
- There would be additional "other costs" associated with training the additional staff specifically with training on existing systems

Implementation costs		
Staff costs	£64k	(1 FTE)
System costs	£500k	
Other costs	£150k	
On-going costs		
Staff costs	£256k	(4 FTEs)
System costs	£50k	

The resource implications with the system operation function will need to be reviewed to understand any impact on shift patterns. This could increase the FTE requirement.

Comment on the capital expenditure is included in the response to Question 3.

Question 2: Do interested parties agree that Ofgem has identified the appropriate benefits of reform of the GDN interruption arrangements?
The delivery of better investment signals is not necessarily reflected in less investment. Allowing Users to price interruption will show the true value of the product. DNs will then have the ability to make commercial judgements when sourcing capacity. Ultimately this should give clarity to the DNs regarding the inclusion of capital expenditure in future price controls.

There are some potential downsides – particularly if Consumers are limited in their ability to access interruption services due to Users market positioning.
In addition, should the market appetite for the interruption product be low, and should DNs require investment, they will be competing for labour to carry out capital projects. This will increase the cost of these projects, may impede physical delivery and may make the economics less transparent.

Question 3: Do interested parties agree with Ofgem's estimate of the range of potential quantitative benefits of GDN interruptions reform?
Ofgem have assumed that investment will be reduced following the implementation of the Interruption reform. DNs plan their networks assuming that under peak 1 in 20 conditions all interruptible loads will be interrupted. It therefore seems logical that any reduction in the level of contracted interruption will require the delivery of additional capacity whether this is purchased from the NTS or from DN investment.

The fact that there has been little or no interruption for the last two winters should not be taken as a sign that the DN Network has excess capacity which was inefficiently acquired. The lack of interruption is purely a factor of the weather experienced both across the UK as a whole and within the DN. This does not affect the requirement to plan for a 1 in 20 winter. In the longer term weather trends become part of the model which looks back across 50 years but this is, by necessity, reactive rather than proactive.

According to the draft Impact Assessment (IA), Ofgem have made assumptions about types of investment that could be avoided if appropriate interruption contracts could be struck with Shippers. It would be helpful to have more clarity about these assumptions.

Customer groups have indicated that the majority of end users would prefer to have a firm gas supply and not to bear the risk of supply interruption. In many cases customers do not have an alternative fuel supply and most have not been interrupted for a number of years due to the recent mild weather conditions. One of the perceived impacts of the regime change is that anyone who offers interruptible capacity, through the tender process, is likely to be interrupted each winter. They may need to invest in alternative fuel supplies or make changes to their business to cope with interruptions. This could mean that customers put a much higher price on the service than the current discount to charges.

It will be up to the DN to analyse whether this is a price worth paying or whether we should look to invest in our Network or procure capacity from NTS. This analysis can only be done in the full knowledge of the DN incentives, NTS charges and GDPCR outcome.

In WWUs GDPCR submissions to Ofgem the assumption made was that there would be no interruptible to firm transfers, the submissions were made on the “as is” scenario (no change to the current interruption model). Initial analysis indicates that WWU will require the same level of interruption under the new arrangements as currently. If market intelligence from Users about the likely take up of interruption contracts is accurate, it seems unlikely that the full volume will be achieved economically through the new regime. To achieve the required peak 1 in 20 capacity DN investment will be required, either through the purchase of additional NTS Exit capacity or in the construction of storage pipeline projects. This has not been included in the GDPCR. Maximum spend would be significantly above our GDPCR submissions. This is the opposite effect to that suggested in the original Ofgem IA which showed global investment efficiencies from £20m to 786m.

The assessment of the efficiency and economics of this investment is the trade off between the revenue generated from the investment and the reduction in LDZ capacity charges caused by the introduction of universal firm status.

CHAPTER Five: DEVELOPMENTS TO THE STRUCTURE OF GAS DICTRIBUTION CHARGES

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

WWU’s Transportation Income team were involved in the development of DNPC01 and the comments below support the DNs view in that Paper.

Our preferred option is to implement the change as soon as possible I.E April 2007. We believe it is extremely important that the proportion of revenue sensitive to throughput be reduced as soon as possible in light of the fact that Allowed Revenue is going to be fixed for 2007/8. If the proposal is not implemented, it is likely to result in larger than normal over/under recovery and subsequent price changes.

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 it with changes in allowed revenue?

WWU believe the benefits outweigh the costs associated with changing the timing of changes to gas distribution charges from October to April. WWU believe there will be minimal costs arising from this change.