Reform of interruption arrangements on gas distribution networks
An update
Comments from Association of Electricity Producers

14 December 2006

Introduction The Association welcomes the opportunity to provide comments on this update document.

The Association of Electricity Producers (AEP) is the UK trade association representing electricity generators. It has some 90 members ranging from small firms to large, well-known PLCs. Between them they represent at least 90 per cent of the transmission connected generating capacity and they embrace nearly every generating technology used in the UK. Many member companies have interests in the production and development of renewable energy where the government has set ambitious targets for development over the next decades.

In the context of this consultation our Members have CCGTs and CHP schemes connected to the DN networks and our response is therefore from the perspective of a large consumer.

GDN Incentives

The Association considers that finding an appropriate incentive structure is a key element that will determine the success or otherwise of the DN interruption reforms. The incentive structure for the first year of operation in 2007 is particularly important as it is at this time that there may be step change in the amount of interruption required, there will also be an interaction with the NTS exit capacity arrangements and also changes to the NTS charging methodology and the DN charging methodology in a timescale consistent with the new arrangements taking effect in 2010.

Whilst we accept that often incentives are refined incrementally we would have concerns if the one year incentive changed substantially from 2008 as part of the new DPCR. Rather it may be more appropriate to adjust some of the parameters within a consistent incentive framework in order to provide DNs, shippers and consumers with some certainty in the approach adopted, such that decisions taken in 2007 are robust for the next price control period. This is because we see the decision process as potentially 'one-way' where if consumers decide to go firm or are no longer required by the DN to be interruptible that they would be unlikely to revert to interruptible status at some later date. This is particularly true if back-up fuel capability had been decommissioned once the site had gone firm to offset some of the LDZ capacity costs. This therefore places greater emphasis on getting the

incentive structure right at the outset. As the incentive structure will influence the DN behaviour and therefore effectively whether or not the reforms are successful, given the 'one-way' nature or the decision from a customer perspective this could indicate that a less onerous (and therefore less risky) incentive structure might be appropriate in the first instance. However this could mean that any benefits (to the extent that they emerge) could take longer to emerge and be reflected in charges to customers.

With respect to the issue as to whether there should be one incentive or separate incentives for NTS capacity, DN interruption and potentially NTS flexibility we would like to see more debate over the pros and cons of these approaches. One of the main drivers for reforming the DN interruptions was to encourage DNs to make efficient trade-offs between investment in its own networks, interruption contracts and NTS capacity and flexibility. This would seem to lend itself to there being one incentive, but the downside of that would mean it would be more difficult to judge performance under the individual elements. We do not consider there is a simple answer to this but that any incentive(s) should be tested against a range of possible outcomes to ensure they are robust.

All three options require some assessment of the volume and cost of NTS exit capacity and flexibility and DN interruption. At this time there is probably most certainty over the NTS exit capacity volumes and perhaps less uncertainty in the cost of this than the other elements. The cost / price of flexibility will be set by auction and the DNs cannot be certain of securing the flexibility they would want at a reasonable price. Similarly the volume / price of interruption offered to the DNs is unknown at this stage and effectively in the hands of consumers and shippers if an open tender approach is adopted as previously indicated, with outturn costs being influenced by the weather. Hence to some extent the NTS exit capacity requirements will be influenced by customers' willingness to be interruptible.

Even given this feedback loop there is more certainty in the bulk of the NTS exit capacity requirements than in the incremental NTS exit capacity required to serve existing interruptibles should they wish to go firm or prove too expensive to contract with. Perhaps it may be possible to establish separate but linked incentives for these?

Given the uncertainties over setting target costs and the risks created by a very strong incentive such as option 2, we would suggest option 3 as the appropriate way forward. This is favoured over option 1 as it effectively has an incentive effect over a wider range of outcomes than option 1 and therefore deals more appropriately with the uncertainty in setting target costs. However this option creates risks of its own in that DNs may take a more cautious approach to their interruption requirements, this coupled with an open tender approach could lead to interruption costing more than it does today! Hence this approach should only be adopted if there is some protection from this outcome in respect of charges being passed onto customers.

Locational Market Power

We consider that sites that are currently NSLs should have the same options open to them as any other site, i.e. whether to go firm or to participate in the tender to offer interruption. However the downside of this is that DNs may need to undertake 'expensive' investment in these locations if alternative offers are not forth coming in that locality. Alternatively DNs may face 'above average' interruption costs in these locations. We have some concerns over whether this treatment of NSLs is consistent with the moderate incentives provided by option 3 where customers meet the costs of interruption. In the absence of further information we are not in a position to judge the extent to which NSLs have locational market power but note that Ofgem is in discussion with DNs on this issue.

Draft Impact Assessment

The Association agrees that assessing the costs and benefits of reform is inherently difficult and a degree of judgement will be required. Also that the actual impact will only be known when the reforms are implemented. In this case we consider that there is particular uncertainty given that the outcome will be driven largely by consumers and shippers rather than the regulated entity in this case the DN. Whilst the DN will be incentivised to make efficient decisions it can only respond to the offers made by customers and shippers for interruption, or indeed the lack of offers. It continues to be a matter for some debate as to how much interruption DNs will require and whether customers will be willing to offer this and at what price.

Whilst we acknowledge Ofgem's top-down approach to the impact assessment that concludes that investment efficiencies would only need to be of the order of 2% for benefits to exceed costs, it is unclear when this will be seen as a reduction in customer charges and what the magnitude of this reduction will be. Such quantification would make the impact assessment more accessible to industry participants.

We also consider that there are other approaches which could be complimentary to this approach. A bottom–up approach would use scenarios to explore a range of possible outcomes, one of which should be the cost of a fully firm network as a comparator. In practice cost benefits will only be seen if the DNs can secure the interruption they require at an overall lower cost than at present when the costs of providing firm capacity are taken into account. So if only 50% of the current interruptible volume was required but that cost three times the current cost then when also taking into account the capex required to provide firm capacity to the other sites this would not seem to support the reforms. Clearly there are a large number of possible outcomes, But through developing these scenarios, which is a robust way of dealing with uncertainty without revealing any detail on individual DN interruption requirements or investment costs then it should be possible to identify a 'break-even' set of scenarios where the benefits equal or exceed the costs. It should then be possible to assess whether the break-even scenarios are plausible outcomes or not.

Security of Supply
We think security of supply issues arise from an interaction between the separate issues of transportation and supply. The drive for efficiency on the DN networks is all about transportation capacity whereas a potential supply demand emergency is not related to transportation, but calls on sites that have transportation interruption contracts to interrupt earlier than sites with firm transportation contracts. Hence changes to the interruption arrangements can have an unintended impact on security or supply. We think that any reduction in interruption requirements at peak will reduce the amount of interruption available at stage 1 of an emergency, making progressing to stage 2 and 3 more likely. In any case a site that does not respond to a request to interrupt in such circumstances could be isolated by the transporter. We do not necessarily share Ofgem's views that only those sites that are prepared for interruption will participate in tenders for interruption, although we think it would be desirable if this were the case

The Association also notes the concerns expressed by the NEC in its comments to modification 90 and would like to understand how these concerns are being addressed.

More flexible market for interruption services
This section identifies the current cost of interruption as £18M p.a and notes that the only way that customers will see reduced charges arising from more efficient purchases of interruption is in a reduction in allowed revenue in future price controls, most likely beyond 2013. The NPV of any such benefits will therefore be small and must be weighed against initial and ongoing implementation costs and the cost of investment to make sites firm that do not wish to participate in interruption tenders. This would seem to make any case to proceed as extremely marginal.

Operation of wholesale electricity market
The Association does not consider that DN interruption reform will have a beneficial impact on the wholesale electricity market since there are relatively few CCGTs connected to the DN networks, these are geographically remote from each other and some of these are firm. Other DN connected generating plant are CHP which have different economic drivers and export less, if any, electricity to the wholesale market. Hence there is unlikely to be more than one CCGT 'competing' to provide interruption for a specific DN constraint.

Ofgem's assertion also relies on competing CCGTs valuing interruption in the same way such that 'efficiency' is reflected in a consistent manner. This may not be the case and may be affected by the availability of other generating capacity in the company's portfolio and the capacity of any back-up facilities.

<u>Gas Distribution Charges</u>
We have concerns over the process by which Ofgem is seeking views on changing the charging year to April to align with price control allowed revenue periods. The issue is hidden at the back of a document with a title that is

unrelated to this issue. We would therefore suggest that Ofgem requests views by a more transparent process such as a separate consultation or open letter. In any case considering change for April 07 seems rather ambitious given that a licence change will be required and it would seem inappropriate to foreshorten the notice periods for changes to charges.