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Dear Mark

National Grid Gas – Offtake Arrangements Final Impact Assessment on modification proposals

We welcome the publication of the above Final Impact Assessment and note the significance of this document in the Authority making a decision on whether to direct the implementation of one of the suite of Modifications (Mods) relating to the enduring NTS offtake arrangements.

We have responded to each of the questions raised in chapters two to four inclusive in the following paragraphs and would particularly like to draw your attention to our comments on page three in response to Ofgem's view that GDNs' costs of implementing these reforms should be excluded from the Impact Assessment. Overall, we do not believe that Ofgem's Impact Assessment accurately reflects the costs associated with introducing NTS exit reform.

Chapter 2. Background

Qu. Do you have any comments on the process associated with the modification proposals that have been raised?

The modification process has enabled various parties to raise alternative proposals to that put forward by NGG. We believe that this has been very important given the strength of feeling surrounding Ofgem's proposed reform and NGG's reluctance to take on board many of the suggestions it has received. For example, SGN raised Mod 0116VD in order to mitigate some of the detrimental aspects of NGG's proposal. That said, we believe it is extremely unfortunate that the nature of the reform being driven by Ofgem has led to a situation whereby multiple Mods have been necessary. It was also particularly disappointing that material amendments were still being

proposed to the modifications only a matter of hours before they were due to be considered by the UNC Mod Panel.

As with all modifications, the provision of draft legal text is critical to ensure that the intent of the modification is accurately transposed into the UNC. Although the production of legal text is currently being progressed, to date it has not been available to the industry for comment. Since this is a key stage to the development of any UNC Mod, it is essential that Users have an opportunity to comment on the legal text prior to any implementation.

Chapter three. Quantitative analysis of benefits and costs.

Qu. We would welcome views on the analysis presented in this chapter.

Analysis of Benefits

Ofgem has been keen to highlight the difficulties associated with producing an accurate and meaningful impact assessment when a number of the benefits are not easily quantifiable. Indeed, it would appear to us that many of the potential benefits of Ofgem's reform fall into the "diffuse and difficult to calculate" category which, in our view, makes any dependence on them to justify the reform questionable. We also believe it significantly increases the risk of introducing unforeseen and potentially detrimental consequences to the regime.

a) Non-discriminatory allocation of capacity products.

Ofgem has reported that the 5% efficiency benefit attributed to the non-discriminatory allocation of capacity products is a wholly subjective assumption. We do not therefore believe that there are any real grounds to attribute a tangible present value benefit of £20.4m or £10.2m (depending on which option is being considered) based on this number. In our view, the fact that Ofgem cannot substantiate the 5% figure used to derive this saving implies that this assessment should not be used as a quantitative benefit. Furthermore, we disagree with Ofgem's assertion in paragraph 3.34 that LTS investment is a substitute for investment in NTS capacity. Rather, they are complimentary products and have been recognised as such in recent discussions with Ofgem on GDN incentive arrangements. Together therefore, we question the ground for present value savings set out in table 3.4.

b) Reduced incidence of ARCA disputes.

We find it surprising that £9.7m has been attributed to benefits associated with the reduced incidence of ARCA disputes. No assessment has been given as to the number of ARCA disputes that have been referred to Ofgem since the GDN sales. However, we are only aware of one, which was due to the unusual circumstances following NGG's consultation on the current ARCA arrangements. Furthermore, it is well

understood that Ofgem determinations on issues such as ARCAs or connection agreements etc, create a basis of “case law” that the industry then draws upon to prevent such issues being raised again. We therefore see no reason to believe that the number of determinations associated with ARCAs is likely to be very high and, accordingly, we question the magnitude of Ofgem’s proposed benefits in this respect.

Analysis of costs

We are concerned that Ofgem’s assessment of the costs associated with this reform is overstated and, therefore, misleading.

a) GDN costs.

Ofgem has stated that it does not intend to “count” GDN implementation costs since these costs should have been reflected by the purchasers of the DNs and NGG as part of the DN sales transactions. This is unacceptable, in our view. Ofgem introduced the concept of exit reform (in various forms) long before the DN sales project. Ofgem then introduced a licence obligation to deliver the reform during the DN sales process. However, at the time of the DN sales, NTS exit reform was still at a conceptual stage with no detailed understanding of what had been proposed by Ofgem and, therefore, it would have been impossible for the purchasers to have made an assessment of the likely future costs associated with it. This is further substantiated by the fact that the reform has taken an additional eighteen months (at least) of debate with significant changes in approach to the nature of products that are to be offered for sale.

In our view, ongoing costs associated with the reform, should it be implemented, would also need to be included as part of the DN’s allowed operating costs.

b) Shipper costs.

Turning now to Shippers’ implementation costs. Ofgem has questioned the magnitude of costs that Shippers have attributed to introducing a commercial flex product. In particular, Ofgem has suggested that a flex “trading desk” will be required infrequently if a commercial flex product for shippers is introduced and, therefore, it believes Shippers’ costs are unrealistically high. However, it is not at all clear to the industry how much flex is actually likely to be available and the analysis carried out by NGG in this respect has been opaque. Throughout the Ofgem-led reform workgroups, NGG persistently referred to the shortage of flex going forward and the need to have a fully functional mechanism to allocate the scarce product. In our view, it would be a bold Shipper that did not implement an internal business solution to manage the proposed commercial flex arrangements to ensure access to all of its flex requirements in every scenario given the importance of the product as it is currently defined and NGG’s assertion that flex will be a constrained product. We therefore believe that Shippers’ assessment of costs that include a manned trading desk to manage access to a constrained flex product is reasonable.

We see no justification for Ofgem presenting a Shipper cost scenario based upon the lowest four Shipper cost submissions.

To conclude on this section, in our view the benefits shown by Ofgem are over-stated. But more particularly, any representation of costs that excludes the GDN costs of implementing reform; GDN ongoing costs; and Shipper costs that are based on the lowest four Shipper submissions is inappropriate.

Chapter four. Qualitative analysis of benefits and costs.

Qu. We would welcome views on the analysis presented in this chapter

In addition to the benefits Ofgem has sought to quantify in terms of £ millions in chapter three, Ofgem has also sought to identify a number of other benefits that it has not been possible to assign a monetary value to but which it believes has an important bearing in the context of this impact assessment. We have commented on some of these below.

Efficient network development and system operation

We do not understand Ofgem's assertion that under the new regime a new CCGT could access capacity earlier than would otherwise be the case under the existing regime. Currently, a new CCGT can get access to capacity if it is available. If it is not, they would be required to enter into an ARCA with an associated lead time which experience has shown can vary and may well be less than the proposed lead time associated with the new regime. In other words, access to existing capacity is equally available and, in our view, it could actually take longer to get access to new capacity under the enduring arrangement when compared to the existing ARCA arrangements. We do not believe therefore that earlier access to capacity under the enduring regime is a valid incremental benefit.

We note that Ofgem believes that targeting the costs of within day flow rate variations at those that cause them would reduce the cost borne by the NTS SO. If this principle is to be carried through, it is logical that NTS entry points should also be subject to flex charges particularly since, over recent years, NGG has persistently stated that it is the flow rate variations at NTS entry points that give them significant system operation and balancing issues. At the very least we would expect to see this benefit flowing through to the NTS SO price control.

Promotion of competition

We continue to believe that it is not necessary for GDNs and Shippers to operate under the same NTS exit arrangements for non-discrimination purposes. In our view, they are clearly very different entities and there is a genuine risk of introducing

unforeseen consequences if a regulated monopoly, with statutory obligations, is required to compete with a purely commercial organisation. While they both may need access to NTS exit capacity, one is for commercial reasons; the other is to fulfil its statutory obligations.

Furthermore, as suggested above, if Ofgem is to pursue the argument that Users of the system should all be treated equally in the common products that they buy, why has the commercial flex regime not been extended to shippers/producers entering gas onto the system?

We would however concur with Ofgem's view that the complexity of the proposed new arrangements and the transactional costs of introducing them are very likely to act as a barrier to entry and therefore rather than increasing competition may actually reduce it.

Preventing undue discrimination

We agree that it is important to ensure that the NTS does not discriminate in favour of its own GDNs particularly in the allocation of the flex product. However, we are mindful that NGG has robust non-discrimination licence obligations in both its NTS and GDN licences and, therefore, any discriminatory behaviour would carry the risk of financial penalties and enforcement action.

That said, we do believe that transparency in the allocation of NTS exit capacity is desirable. However, we believe that this could be achieved by making modifications to the UNC other than those associated with Ofgem's preferred NTS exit reform. We also note that the benefit Ofgem has attributed to the impact of the proposed reform on firm and interruptible sites could be achieved by other means such as the arrangements currently being considered in respect of DN interruption reform.

In other words, although Ofgem has attributed to the proposed NTS exit reform modifications benefits of preventing undue discrimination, we believe that the benefits could be achieved via other means.

Conclusion

To conclude, we believe that Ofgem's Final Impact Assessment of the NTS exit reform proposals overstate the potential benefits in terms of both its quantitative and qualitative assessment. In particular, we believe that any assessment that excludes the costs the GDNs will incur in implementing the reforms on the grounds that these costs should have been taken into account within the DN sales negotiation with NGG is inappropriate. We firmly believe that these costs should be included in the costs of the introducing the reform and, accordingly, allowed as legitimate expenditure to feed into the calculation of the GDNs' allowed revenue. Likewise, the GDNs' ongoing operational cost should be included.

In our view, we do not believe that it is necessary for the same NTS exit arrangements to apply to directly connected sites and GDNs and we believe any potential issues associated with the allocation of NTS exit and flex capacity could be addressed via the implementation of other, more simple changes to the UNC.

Yours sincerely

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Regulation Manager