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Review of NTS entry charge setting arrangements – Impact Assessment June 2010

Dear Richard

We welcome the opportunity to comment on this Impact Assessment. The arrangements enabling access to the gas network in an economic and efficient manner are an important element of a well functioning GB gas market. This response is provided on behalf of the RWE group of companies, including RWE Npower plc and RWE Supply and Trading GmbH.

With the current auction-based approach to allocate entry capacity, it must be recognised that fluctuating commodity charge levels are an inevitable outcome as auction revenues will never exactly collect fixed allowed revenue.

The proposals that are the subject of this Impact Assessment are designed to increase the proportion of allowed revenue NGG recovers through firm entry capacity charges. In turn, this should reduce the level and volatility of the TO Entry Commodity Charge. We agree with this objective as the TO Entry Commodity Charge is not cost-reflective and increases in its level progressively commoditise a charge that should be a capacity charge.

However, we recognise that implementing the specific package of proposed changes will not address all the relevant factors and may create inefficiency by artificially constraining interruptible volumes and setting short-term reserve prices above the cost of providing capacity. Ofgem's Impact Assessment indicates that the proposals may not meet the declared objectives and that market distortions arising from them may create costs that outweigh any benefits. On balance we agree with Ofgem's initial view to veto GCM19 and reject UNC proposals 0284 and 0285. We do not support partial implementation of any of these proposals and consider that a review of the entry capacity arrangements, including charge setting, might be considered under TPCR5.

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Our response to the specific questions is included in Attachment 1. If you wish to discuss any aspect of our response, please do not hesitate to contact me.

Yours sincerely

Charles Ruffell
Economic Regulation

ATTACHMENT 1: Consultation Questions

CHAPTER 3: Industry views on proposals

Question 1: *Do you agree with NGG's analysis on the impacts of removing the reserve price discounts?*
We agree with the that removing the reserve price discounts should result in more of NGG's allowed TO entry revenues being collected through capacity charges, with a consequent reduction in the shortfall to be collected by the TO Entry Commodity Charge. NGG's quantitative analysis suggests a range of benefits depending on the degree of secondary trading that occurs.

CHAPTER 4: Key impacts of proposals in relation to relevant objectives

Question 1: *Do you agree with our analysis of the proposals against the appropriate objectives?*
Ofgem is correct to consider the proposals individually against the wider set of objectives, but overall, we think that the proposals will only work if implemented as package.

UNC0284
Reserve prices: In principle, we agree that network users should face prices that reflect the cost of providing network access and that these costs might vary over the timescale that access rights are acquired. However, we are not completely convinced by Ofgem's argument that a premium, relating to certainty, should be included in the reserve price of long and medium term capacity, especially as the regime is based on financial rather than physical access rights. It is not clear that capacity rights acquired 15 years ahead confer any different rights for Users than firm capacity made available and acquired day-ahead. The structure of the capacity release obligations on NGG, coupled with reduced levels of peak bookings compared to obligated entry capacity ensure that firm capacity is not generally scarce in the short-term and is no less certain to be available than that acquired long term. There is a stronger case for a premium between firm and interruptible capacity, but even here the current release mechanism creates little risk of interruption.

Cost reflectivity:
We agree that network users should face cost-reflective prices. To the extent that the proposals under GCM19 lead to a reduction in the TO Entry Commodity Charge then they will improve cost-reflectivity, as the TO Entry Commodity Charge is not cost-reflective and may be above the SRMC. We do accept that the improvement is modest, however.

Developments in the transportation business: The use of auctions will always cause NGG to over or under recover against its allowed revenue and create the need for an adjustment mechanism. Ofgem has characterised the current position as one where NGG fails to recover its allowed revenue through auctions; capacity at the majority of entry points is not fully used; there are low levels of competition for capacity in the short-term; NGG has baseline obligations to release capacity and incentives to release capacity beyond these baselines; and obligated levels of capacity are far greater than system peak usage. We agree with this view and believe that the arrangements should be reconsidered in the context of the upcoming TPCR5.

UNC0285
Efficient and economic operation of the NTS: The availability of interruptible capacity is a feature of an efficient network designed to meet peak firm requirements and it should be made available at zero reserve price. We agree that if considering UNC0285 on its own, restricting the availability of interruptible capacity is not appropriate.

Securing effective competitive: We agree that on its own, UNC0285 would of little in this regard as firm would still be available at zero reserve price on the day. A key reason for our support of these proposals was the stimulation they might give to secondary capacity trading and it is disappointing that, on balance, Ofgem believe that there would only be a modest impact and that any benefit might be offset by reduced liquidity. It remains unclear to us how much of a barrier to delivering gas in the short-term is created by non-zero reserve prices for entry capacity, particularly given the relative levels of the entry capacity costs and wholesale gas commodity prices. However, we accept that it might create a barrier at the margin.

Question 2: *Do you agree with our provisionally preferred approach which would be to not implement any proposal to reallocate the revenues from baselines?*
The change required under the so called "Proposal 3" is an important element in maximising the TO revenues from capacity sales. Given the complexity of the current split of TO and SO activities and revenue flows in the Licence, we agree that more analysis is required and that a change should not be made.

Question 3: *Are there any other factors we should consider?*
We have not identified any other factors.

CHAPTER 5: Key impacts of options

Question 1: *Do you agree with our analysis of each of the options against the measures we consider?*
The analysis of the interactions between the proposals and the effect on TO auction revenue and TO **Entry** Commodity Charge is reasonable.

Question 2: *Are there any other measures we should have assessed the options against?*
None identified.

CHAPTER 6: Assessment of other impacts

Question 1: *Do you agree with our analysis on the impacts of the options on existing and future consumers being their interests as a whole in terms of both security of supply and reduction of greenhouse gases?*
We agree that the proposals will not materially affect the aggregate amount of gas flowing through the NTS.

Question 2: *Do you agree with our analysis on the impacts on health and safety?*
We agree.

Question 3: *Do you agree with the risks and unintended consequences we have identified?*

The intended consequence of the proposals is maximising the amount of TO entry allowed revenue recovered from auctions. We accept Ofgem's analysis that there could be a range of outcomes, depending upon the behavioural changes that arise and that restricting available capacity, either by price or introducing a trigger mechanism may lead to gas being withheld.

Question 4: *Are there any other impacts we should have addressed?*
Regulatory certainty is important for existing industry participants and new entrants alike and forms an important component of investment decisions. Whilst there will always be an element of uncertainty, this needs to be minimised with transparent drivers for regime change.

CHAPTER 7: Conclusions and way forward

Question 1: *Do you agree with our conclusions?*
Ofgem's Impact Analysis has set out a number of quantitative and qualitative arguments that the proposals may not meet their objectives to increase the proportion of NGG's allowed revenue that it recovers through entry capacity charges, so that the level and volatility of the commodity charge is reduced. In addition, the proposals may not be consistent with wider statutory and licence conditions. On the basis of the arguments presented, we agree with Ofgem's conclusions.

Question 2: *Are there any other issues that need to be raised to inform the Authority's decisions on these proposals?*
The Impact Assessment includes a table that sets out the key changes to the gas transmission entry regime which have led to the current auctions regime. These changes have, in part, been in response to changes in the operation of the auctions. Initially, from 1998 to 2002 there was significant revenue over-recovery, but in general since 2002 auction revenues have increasingly under recovered in relation to the TO entry allowed revenue. Charging changes, UNC modifications and licence changes have all been required to finesse the arrangements.

From 2012, the industry will be operating under revised NTS exit capacity arrangements in addition to the revised DN interruption arrangements from 2011. Given our comments about regulatory certainty, we would urge the Authority to be mindful of the lessons learned for the entry capacity regime when considering further developments at exit, notably substitution, and in particular minimising the extent and frequency of regime changes.