taking care of the essentials

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Sonia Brown
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Dear Sonia

National Grid Transco – Potential sale of gas distribution network businesses Final Impact Assessment

Centrica Storage Limited ("CSL") offers the following views in response to the request for comments on the potential sale of gas distribution networks ("DNs"). Although CSL has no objection in principle to the sale of the DNs, we are of the view that the business rules considered to date at the exit regime development forum ("ERDF") would act to the detriment of storage, interconnector and other interruptible supply points.

Given the prospective complexity and impact of such rules, CSL currently favours **the no-sale option**, based on the current proposed offtake rules versus the status quo.

This decision is based on the information made available through the ERDF and we recognize that this forum will continue to meet into the New Year. Transco are proposing to consult on the exit business rules, and Ofgem are to bring forward incentive proposals in January 2005, both of which will better inform the implementation of any changes to the exit regime proposals from 2008. In addition, all interested parties will in due course have the opportunity to comment on a modification to insert the new exit arrangements into the proposed new Uniform Network Code (UNC).

CSL would be most concerned if the proposed exit regime was inserted directly into any final UNC without this proposed modification, as has been minuted at Modification Panel meetings, as there would be no direct means for Ofgem to assess the exit proposals against the relevant objectives and Ofgem's wider obligations under the Gas Act.

Fundamental Concerns with the Proposed Offtake Arrangements

Full-year Materiality

Given the massive difference between winter and summer demands, we do not think that it is efficient or appropriate to introduce a system which implicitly requires similar effort for exit capacity throughout the year. We recognize that annual capacity will be available, but "exit economics" fundamentally should focus on winter balancing and requirements, and the approach considered to date have failed to adopt such a focus. Without any seasonal shape to long term auctions, it is unlikely that any storage shipper will indicate a willingness to secure long term firm exit rights at storage sites, yet Transco should know that capacity will be sought and utilised in line with current practice and is required by the Safety Case.

Perverse outcomes

The foreseeable practical outcome will be that incorrect incentives direct the industry in an inappropriate fashion. Storage activities present a convenient example but not the only one. At present storage users can get interruptible exit rights at storage connection points, and generally do so and thus pay no exit charges. This cannot involve undue discrimination, since storage users will normally be withdrawing from storage and entering gas into the NTS on days when Transco might wish to interrupt exit flows and thus on days when exit capacity should have real value.

For example, over the last 5 years, Rough shippers took 89% of their total NTS exit (storage injection) requirements during the April to October periods, and the remaining injections naturally avoided the days of maximum demand levels and maximum market prices (e.g. days where demand is far above SNT). Indeed, it is a requirement of the Safety Case that storage levels are above the safety monitor levels as introduced following implementation of modification 710 (removal of Top Up).

If storage users have to buy full-year firm exit rights and seek to sell their "interruption" rights to Transco, Transco would assess the value at nil as they can expect no reduction in demand by exercising interruption rights on high-demand days when injection flows should be zero. As you will be aware, Transco have only interrupted storage exit flows once, and that was at Easington in July 2003 in response to a "transportation problem" rather than for overall supply/demand reasons.

In addition, we consider the exchange rate principles to be unduly complex and likely to confuse the nodal to zonal distinctions.

We believe that the effective annual value of exit capacity at “seasonal” storage connection points must effectively be zero, and any methodology which gives a different result or which requires unnecessary effort to avoid cost must be fundamentally flawed.

Flow Flexibility Product (“FFP”)

We believe that Transco must take full account of the benefits that physical swing providers bring to the NTS. This swing enables shippers, with Transco acting as the residual balancer, to match supply/demand on the system. Whilst understanding that Transco need to ensure that the DNOs and retained DNs do not make inefficient investment decisions for the provision of diurnal storage, applying a FFP charge to every NTS off-take point will have unintended and undesirable consequences on the operation of both gas and power markets.

CSL’s main concerns regarding the FFP relate to

- allocating this aggregate charge on multiple shippers across bi-directional meter points
- shippers unable to know/forecast the FFP charge within the gas day and having no input into physical flows regardless.
- the risk that the FFP may encourage back-profiled injection rates, which would reduce the potential availability of UIOLI storage capacity

We are concerned the FFP will encourage physical profiling of nominations towards the end of the gas day so as to avoid the difficulties associated with allocating gas to shippers.

CSL notes Transco have suggested interim arrangements that require DNs and Direct Connect customers to only request additional flow flexibility from Transco above that allowed in the NExA. CSL considers this to be a preferable solution that would maintain some consistency with the current regime whilst allowing all NTS offtakers the opportunity to value flows above their current contractual requirements, with these valuations reflecting the tighter supply/demand situation brought about during periods of higher demand.

Allocation

A major concern for CSL would be the allocation arrangements for multiple user exit points (especially storage points) where customers’ nominations are held whole but the storage customers have no say in the way the storage operator chooses to flow (or trade) out of any position. This concern is lessened to an extent if the FFP was removed, as Transco should be able to allocate exit overrun charges in much the same way as are levied for storage withdrawals and the requirement for shippers to purchase entry capacity. Even with this example, it is possible that any charges would not be cost reflective due to the bi-directional nature of storage (and some interconnectors). We are unclear at this time as to how storage operators could pinpoint in aggregate which shipper had generated a charge when storage nominations are not necessarily matched by physical flows into storage facilities.

UIOLI Exit Capacity

As storage shippers currently utilise interruptible capacity, we consider the UIOLI provisions are of critical importance in maintaining consistency of approach to existing commercial arrangements at storage points. CSL favors release of UIOLI at a day-ahead stage up to peak system capability. Given the benefits afforded to the NTS by storage operations we would recommend that zero exit reserve prices are normally appropriate at storage connection points and also at other nearby exit points other than at high demand levels, say 85% of forecast peak-day firm demand.

It has been suggested by Transco that the amount of capacity available on a UIOLI interruptible basis would be a function of capacity sold in the long to medium term. CSL has fundamental concerns with this suggestion. This runs counter to the fundamental tenet behind UIOLI, namely that unused capacity whether "booked or not" should be available to those who can and would use it. Restricting UIOLI below the physical maximum available would merely imply permitting hoarding by the transporter.

We appreciate that restricting UIOLI capacity should put some emphasis on annual and longer-term capacity. However this again appears to ignore the fundamental point that costs are best focused on the exit requirements creating the marginal demand i.e. at peak periods.

We can see no industry-wide benefit in this concept and view the current arrangements as more efficient.

Phased Implementation and Investment Signals

If such a model is implemented it would require an active within-year and within-day market to have any meaningful degree of efficiency. Creating the opportunity for a market to exist does not ensure that a liquid and active market will quickly emerge, if at all. In the case of exit capacity, the benefits from trading are unlikely to be material for most Users in relation to their needs to address other risks and opportunities. Hence exit capacity "markets" and trading will develop very slowly other than possibly at Bacton.

There is therefore a substantial risk that despite careful design of the new "exit" system it will not achieve its aims because of administrative complexity and cost in relation to the benefits sought and available.

Investment Signals

It seems evident that it is most important that the offtake model sets and sends good "signals" at high demand levels. CSL therefore suggests that there should be an initial phase focusing on the operations and incentives at high levels of system demand. It is possible the ERDF could continue design and development as at present but for an initial phase to have Exit capacity and FFP over-run charges set to zero on days when system demand is less than say 80% of Transco's published firm peak-day demand forecast for the current Gas Year.

Such an initial phase should last for at least one complete Gas Year i.e. 2009. The subsequent phase could involve full implementation, reduction of the "[80%]" threshold to a lower level (to extend the involvement and discipline without necessarily going to full implementation), different demand thresholds at different periods, and lesser discounts at different periods, etc.

CSL would recommend that the decision on the "phase 2" rules is delayed until there has been a full year of "phase 1" operation and a full review of its impact, and that then the movement to "phase 2" allows adequate notice for affected parties to make appropriate preparations. CSL strongly recommends such a "phased" implementation for the rules adopted if the proposals as currently defined are thought to further the relevant objectives.

It is interesting to note that Transco's new Ten Year Statement recognises that even after 2 years, "in relation to existing entry points, the [entry] auctions are still to provide us with clear signals that would justify investment above the baseline adopted for [the] present price control". Consequently, the industry should be concerned that so much of the existing offtake proposals are being driven by a desire to replicate the investment signals on entry into the exit model, where there is actually no evidence of helpful signals.

Should the impression of scarcity in the availability of interruptible UIOLI capacity at storage sites continue to be a feature of the offtake business rules, then storage and interconnected sites may have to signal a requirement to purchase a financially firm product. It is likely that Transco will then receive distorted signals on investment in the NTS, resulting in investment beyond that which would otherwise be required. CSL considers this cannot be consistent with the Gas Transporters licence obligation to develop and maintain an efficient and economical pipeline system.

Moreover, CSL considers that storage and interconnector sites face undue discrimination from the proposed amendments to the offtake arrangements when considered against the status quo.

Please contact me should you wish to discuss further. CSL does not consider this response to be commercially sensitive.

Yours sincerely

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