

Inveralmond House
200 Dunkeld Road
Perth
PH1 3GH

Direct Tel: 01738 456400

Direct Fax: 01738 456415

Email: rob.mcdonald@scottish-southern.co.uk

08 September 2005

Mark Feather
Associate Director, Networks
Office of Gas and Electricity Markets
9 Millbank
London
SW1P 3GE

Dear Mark

Urgent Modification proposals 0036: Limitation of incremental capacity offered in QSEC Auctions and 0043: Limitation on offering for sale unsold capacity

Thank you for providing Scottish and Southern Energy plc with the opportunity to comment on Ofgem's consultation into the above urgent modification proposals.

As you will have seen from SSE's response to the UNC consultation, we are opposed to both of these proposals and do not support their implementation. Having carefully considered Ofgem's initial views, we remain of this view for the reasons set out below.

General comments

We are concerned that these proposals would fundamentally change the basis of the NTS entry capacity regime and would therefore be of significant commercial consequence to Transco NTS, shippers and ultimately customers. In particular, of most concern is the proposal that Transco could be able to withhold unsold entry capacity from the market, be it baseline or incremental obligated, in any of the auctions to be held prior to the end of the current price control period. As well as potentially undermining the commercial decisions that have been taken by market participants, such an approach would distort the existing price control and incentives framework, and result in a further "churn" of costs which would be recovered only from shippers and ultimately passed on to customers.

We also believe that the issues at stake are sufficiently complex to warrant more detailed consideration than has been afforded by the urgent UNC modification process. More generally, the current situation illustrates, in our view, that auctions for transmission capacity are incompatible with a long-term investment framework. We therefore believe that serious consideration must be given to whether it remains appropriate to continue with this regime at entry, or for that matter whether similar arrangements should be introduced at exit. Against this background we would urge Ofgem to consider these issues from first principles as part of the NTS and SO price control reviews, rather than piecemeal reform through the UNC modification process.

However we do accept that further consideration might need to be given to the three year lead time because in some circumstances there could be a requirement for a longer timescale to build a physical asset. We would note that the three year lead time drives the firm financial commitment from shippers to the NTS entry capacity product, it does not drive all investment planning and preliminary works. This point notwithstanding, if physical investment does indeed take longer than three years, this would appear to be an issue with *timing* of the auctions, which may therefore need to be held further out than three years.

In addition, if in the interim Transco believes that its exposure to buy back costs will be so extraordinarily high, which is difficult for us to judge as there has no indication of the materiality of these potential costs, it could apply for an Income Adjusting Event which has a tried and tested regulatory process.

Finally, as we understand it, Transco NTS does not currently have any incentive mechanism in relation to buy back costs more than three years out. As a consequence we do not understand why a modification is required to address a potential cost and risk to Transco that does not presently exist.

We have laid out some more detailed comments on the proposed Modifications in the attached appendix and hope that you will find our comments useful. If you would like to discuss our response to the paper, or the licence requirements more generally, please feel free to call.

Yours sincerely

Rob McDonald
Director of Regulation

Appendix

Urgent Modification 0036

- The purpose of the IECR methodology statement is to set out how Transco NTS determines any incremental volumes of capacity to be released following the long-term auctions. The UNC, whilst obliging Transco to offer up to 150% of baseline for sale in the QSEC auctions, does not prescribe how Transco NTS then decides to release any incremental capacity above the baseline volume. To us the issue would appear to be not the obligation to offer for sale, but the subsequent methodology by which Transco NTS would release incremental capacity (above baseline) to shippers.
- We note that Transco NTS is of the view that the UNC is now at odds with the recent changes to its IECR methodology statement, which Ofgem did not veto and that this is the rationale behind raising this proposal. We do not believe that Transco has sufficiently explained why this is necessarily the case and in particular we do not believe that the change to the IECR methodology necessitates this modification. In any event, if the two are linked we believe that Transco should revert to its previous IECR methodology rather than implementing this modification.
- SSE remains unclear about the impact the proposal would have on new entry points where there is no existing baseline. Although we raised this point in our response to the UNC consultation, it has not been addressed in the Final Modification Report.
- If the proposal is to go ahead, we are firmly of the view that any approval by Ofgem not to release the 150% of baseline should be given before the auction is conducted.

Urgent Modification 0043

- If implemented this proposal has the potential to distort the entry capacity regime as Transco would be able to withhold unsold entry capacity from the market, be it baseline or incremental obligated, in any of the auctions to be held prior to the end of the current price control period.
- As well as potentially undermining the commercial decisions that have been taken by market participants, such an approach would distort the existing price control and incentives framework, and result in a further “churn” of costs which would be recovered only from shippers and ultimately passed on to customers.
- This is because revenues associated with both baseline capacity and obligated incremental are allowed to be recovered via the TO and SO controls respectively. Transco NTS has failed to provide any indication of the materiality of its proposal, either in terms of the volumes of capacity that could be involved or the number of entry points affected. It has not quantified in any way the extent to which the industry is at risk from it incurring significant additional buy back costs. We do not believe that this proposal should be implemented until Transco has demonstrated whether such costs exist.
- However the ramifications of implementing this proposal will be for any shortfall of either TO or SO revenue to be recovered from those shippers who have already purchased NTS entry capacity. This would place all the commercial risk on those parties who have made a long-term purchasing decision, which in theory is supposed to be lower risk. By contrast, those who have not purchased entry capacity in the long-term auctions run the risk that they will be unable to procure the capacity at all, or if they can it will be at an inflated price. All the financial risk of withholding capacity for sale is therefore being placed upon shippers and ultimately customers, with Transco NTS bearing no risk.

- We remain concerned that if the proposal is implemented there is a significant risk that gas would be stranded in storage facilities where typically parties buy entry capacity on a seasonal and short-term basis. Shippers will be unable to access valuable swing gas, which could have a detrimental effect on security of supply.
- We are unclear how a provision in the UNC could potentially “over-ride” an existing licence obligation, namely the obligation on Transco to release all baseline capacity to shippers. We also believe consideration should be given to what would happen if the circumstances change and Transco were subsequently able to release the capacity to the market. How would this be audited and any revenues treated?
- Finally, we also have concerns regarding the precedent that could be set were this aspect of the entry capacity regime to be replicated at NTS exit points. If the proposal is to be implemented we support Ofgem’s view that as drafted, the proposal provides Transco NTS with far too much discretion regarding the way in which it releases existing unsold capacity (including and above baseline). In particular, it is not acceptable that there are no safeguards in the proposed UNC legal text. We note that at the Transmission Workstream last week Transco NTS indicated that it envisages that any application to the Authority would not be subject to consultation with interested parties. That is, that the first shippers would be made aware that any baseline or incremental obligated entry capacity would not be released for sale would be at the time of the auction invitation and after Ofgem had granted its approval.
- We believe that interested parties should have the opportunity to comment on the criteria and rationale that would drive an application for consent by Transco NTS. An additional safeguard could be to incorporate such criteria into the legal drafting that would feature in the UNC.

Conclusion

In summary, SSE is firmly opposed to the implementation of these proposals.

- We continue to believe that the issues of concern to Transco NTS are not matters to be resolved via a UNC modification proposal or proposals and are best addressed via the forthcoming price control review.
- Transco NTS has still failed to quantify the materiality of the situation were these proposals not to be implemented. However it would appear that the commercial risk of implementing these proposals lies entirely with shippers and ultimately customers.
- We are concerned that the UNC modification process is being used as a route to implement changes, which would be more properly dealt with via other governance processes.
- We do not consider that implementation of the proposals will better facilitate the relevant objectives.
- If Ofgem decides to approve the proposals, we suggest that any further changes to the legal drafting be subject to further consultation prior to implementation.