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User Commitment for National Transmission System Quarterly Entry Capacity
Initial Impact Assessment on modification proposals
October 2009

Dear Paul,

We welcome opportunity to comment on this Initial Impact Assessment. This response is provided on behalf of the RWE group of companies, including RWE npower and RWE Supply and Trading GmbH.

Review Group 0221 considered whether the credit arrangements associated with booking gas entry capacity in long-term auctions were sufficiently robust and provided the correct balance of risk between parties. A series of UNC modification proposals[1] were subsequently raised to address some of the issues identified.

In principle, we believe that Users should face fully cost-reflective liabilities ahead of utilisation of any entry capacity triggered in the QSEC auctions. This will provide the correct economic signals to Users that wish to deliver gas and, in turn, lead to efficient investment in transmission infrastructure. It also leads to an appropriate amount of risk sharing between new and existing Users. If new Users are only obliged to underwrite a proportion of the investment liabilities ahead of utilisation, it leads to a situation where the balance of any costs is recovered from existing users which is an inefficient outcome. Once the infrastructure has been included in the RAV then under (and over) utilisation is subject to a form of mutual insurance in terms of the annual review of transportation charges to align actual to allowed revenues.

We accept that this issue is complicated because of the way access rights onto the NTS are defined and allocated. The release of financial rather than physical rights over different time frames means that capacity is allocated without a direct linkage to any actual investment which

[1] 0246, 0246A and 0246B "Quarterly NTS Entry Capacity User Commitment"

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makes it difficult to target costs to specific User projects. The problem is further complicated where no actual investment takes place.

This framework based on commercial rights is reflected in the capacity incentive mechanism within the NGG transporter licence. This allows NGG to trade-off investment against buy-back and for the System Operator to take inventive revenue for releasing incremental capacity irrespective of requirements to undertake investment.

Having considered the information set out in this Impact Assessment, our view is that the costs of implementing the UNC Modification Proposals far outweigh the benefits. This is particular true for UNC0246 and UNC0246A which both require securitisation of historic and future capacity bookings. We are not in favour of applying market rule changes retrospectively as this introduces an unacceptable degree of regulatory risk into the regime and undermines willingness to undertake long-term capacity bookings. We do continue to support UNC0246B as it is the least-cost option, retains the full range of credit tools, is not applied retrospectively but treats all future capacity holders on the same basis.

However, UNC0246B delivers only a partial solution and fails to address the more fundamental market design issues that we highlighted above. It would, therefore, seem appropriate to consider wider changes to NGG's Gas Transporter Licence and associated incentive arrangements. Ofgem has set out a number of possible approaches to deal with an issue that is an inherent feature of the entry capacity arrangements. Our preference would be for further consideration to be given to widening the Income Adjusting Event provisions and reviewing the revenue driver and incentive mechanism. However, given the need for regulatory stability in the regime and certainty for NGG in undertaking its investment decisions, these are best considered as part of TPCR5.

Our answers to the specific questions raised in the consultation document are included as an attachment.

We hope these views are helpful and would be happy to discuss them further.

Yours sincerely,

By email so unsigned

Charles Ruffell
Economic Regulation

ATTACHMENT 1: CONSULTATION QUESTIONS

CHAPTER: 2

Question 1: Do you have any additional views on the merits/disadvantages of the options for securitization of capacity to add to those of the review group?

We think that all the options represent a partial solution and do not address the risks that are inherent in the regime design. The release of commercial rather than physical access rights makes it more difficult for the User triggering the incremental capacity to underwrite the costs.

Question 2: Do you have views on the ability for NGG to cover the potential of shipper default through commercial insurance instruments?

In principle this could be an option but the costs are likely to outweigh the size and frequency of the risk being covered and Shippers may also be able to procure less costly instruments. It is also unclear whether insurance could be applied to this type of credit default risk.

CHAPTER: Three

Question 1: Do you agree with the analysis of the risks involved? Are there any quantifiable risks that have been omitted?

The analysis appears to be comprehensive.

Question 2: Is the level of securitization being proposed appropriate? If not, why?

Our preference would be for all of the project costs triggered by the release of incremental capacity to be underwritten by the User that bid for that capacity. This would protect fully the wider community, reduce the risk of speculative bidding and ensure that bidders are doing so on the basis of a viable project. It would be analogous with the Final Sums Liability arrangements in electricity. We do, however, accept that the two markets are not directly comparable due to the way rights are defined (physical versus commercial) and allocated.

Question 3: Do you agree with the benefits as presented here? Are there any other ways in which the quantitative benefits could be presented?

We agree with Ofgem that it is not straightforward to present the quantitative benefits and those presented give an indication of the scale of the issue.

Question 4: How do the risk ranges presented for each of the proposals rank against your perceived risk of default for future capacity bookings?

There may be a growth of single shipper bidders, but the UNC proposals do not fully remove the risk that costs will be incurred by the wider community should any of these Users default. On this basis, there is only a modest improvement over the current position.

Question 5: Do you have any preference amongst the proposals on the basis of the quantitative analysis?

The level of capacity default required to justify the implementation costs of the proposals suggests that none should be implemented. On the basis of it being the lowest cost we are prepared support UNC0246B.

CHAPTER: Four

Question 1: Do you think that the implementation of any of these proposals would have an adverse effect on competition? Please give reasons for your answer.

We think that the proposals that involve retrospective application will undermine confidence in the market as regulatory uncertainty will be introduced in the regime. This is likely to discourage long-term capacity bookings.

Question 2: Do you think any of these proposals are unduly discriminatory?

No.

Question 3: Do you think the proposals are sufficiently simple and transparent?

The rationale behind the proposals is reasonably clear, although the estimation of credit requirements ahead of the QSEC by Users introduces an additional level of complication. The example of entry capacity bids at Easington and Hornsea in 2006 demonstrates the difficulties that shippers may face in securing capacity where the auction reveals strong demand for capacity at an ASEP.

Question 4: What is your preference on the basis of the qualitative issues?

We continue to support UNC0246B.

CHAPTER: 5

Question 1: Do you think that shipper termination is a tool that should be more widely used to deal with credit default issues?

On its own it will only have a limited impact and needs to be used in conjunction with, for example, changes to the way in which NGG's revenue drivers are triggered.

Question 2: Do you agree that the Income Adjusting Event clause in the gas transporter licence should be reviewed? If so, what manner of changes would you recommend?

Extending the IAE arrangements is an option that should be considered further. However, recourse to IAE mechanism must retained for exceptional circumstances only and therefore the triggers must be carefully defined.

Question 3: Do you agree that the revenue driver mechanism for gas entry capacity could be improved? If so, how?

We agree that the revenue driver mechanism should be reviewed but that this is best considered during TPCR5. There is clearly a balance to be struck between providing NGG with an incentive framework to respond to incremental capacity signals and that framework increasing the risk of stranded assets. Buy back, which has been noticeable by its absence during the current TPCR, should also be reviewed in this context.

Question 4: Do you have a view as to whether the Authority's role in the approval of NGG NTS proposals to release incremental capacity is no longer required?

We think that this role provides a useful sense check on NGG and will be increasingly important should Capacity Substitution be implemented.

Question 5: Are there any other options, outside of the UNC, that could be considered for making the entry capacity credit arrangements more robust?

Absent fully cost-reflective liabilities for Users triggering incremental capacity, we think that there may be merit in developing a proxy for these costs to sit within reformed credit arrangements.