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**Pricing Discussion Papers NTS GCD01,02,03 – Flat and Flexibility Capacity
Charging and Recovery of TO Allowed Revenue under the Enduring
Arrangements from October 2010
Comments from the Association of Electricity Producers**

The Association of Electricity Producers (AEP) is the UK trade association representing electricity generators. It has some 90 members ranging from small firms to large, well-known PLCs. Between them they represent at least 90 per cent of the transmission connected generating capacity and they embrace nearly every generating technology used in the UK. Many member companies have interests in the production and development of renewable energy where the government has set ambitious targets for development over the next decades.

The Association welcomes the opportunity to provide comments on these pricing discussion papers.

GCD01 – Flat Capacity Charges

Question 1

The Association would support the introduction of a transportation model. We have been actively involved in the TCMF meetings and consider that the issues of stability, transparency and repeatability favour a transportation model based on a one year supply/demand scenario. Whereas the TRANSCOST model is more complex, requires more assumptions concerning supply/demand scenarios in future years and needs skilled users to optimise the compressor and regulator settings. Hence it is less likely that a TRANSCOST model could be made available to the industry in a sufficiently user-friendly manner to be useful and provide repeatable solutions. TRANSCOST also appears on occasion to set counter-intuitive charges.

We therefore consider that moving to a transport model will produce charges that are less susceptible to subjective assessments and better suited to a network that is seeing significant changes in system flows rather than incremental changes at existing entry points.

We consider that this is consistent with the relevant objectives in reflecting the costs incurred. Since the actual costs are annuitised it is appropriate that charges should exhibit a degree of stability over the asset life time. It is also consistent with taking account of developments in the transportation business since this review was prompted by the output of the TRANSCOST model under new supply/demand conditions which resulted in much discussion which required further investigation. Also it is anticipated that the transportation model should give rise to more stable and predictable charges overtime and this is consistent with promoting competition between shippers and suppliers as they need to factor in these charges to their tariffs.

Option1 vs. Option2

We support an approach that includes a backhaul benefit but excludes spare capacity. We agree that this needs to be considered in conjunction with a single vs. multi-year approach. The single year approach is favoured as it will most accurately reflect the network in the year in which the charges are to apply, and hence be most cost reflective of that network. The multi-year approach requires forecasts of supply/demand further into the future which inevitably will be less accurate. In addition averaging over the time period will dilute temporal price signals.

The inclusion of spare capacity in a single year approach, whilst perhaps theoretically desirable would seem to lead to unstable charges. It appears that this arises from the lumpiness of investment and the transient nature of spare capacity; hence it may be more pragmatic to exclude spare capacity. A further consequence of including spare capacity would be a see-saw effect in charges with charges being close to zero when spare capacity is available which would be just before growth leads to scarcity and immediately after investment hence charges would not reflect the LRMC of the asset over its useful life – leading to an under-recovery of the investment cost.

The use of a reference node seems most appropriate and consistent with a backhaul benefit being included but no spare capacity. We understand that the choice of reference node is immaterial if the entry / exit split is adjusted at a later stage. We consider such approach is consistent with the relevant objectives.

Question 8

Prices are already set at the nodal level for all offtakes other than those serving the distribution networks, so the question is whether nodal prices should be set for DN offtakes. Following the comments in paragraph 5.43 in the TCMF Progress Report PR01 that ‘the allocation of LDZ customers to NTS exit zones is a DN activity’ it would seem reasonable to set charges for each offtake individually to ensure that the DNs respond appropriately to the locational signals provided in the context of its wider obligations and incentives. We would also expect to see further papers considering consequential changes to the DN charging methodology so that customers may understand the full impact of these proposals.

Question 9

We agree that it seems appropriate to convert the LRMCs into charges using the annuitisation factor in NTS GT licence.

Question 10

We support the removal of year-on-year capping in principle as we recognise the limitations this can cause, particularly a departure from cost-reflective charges. However we consider it is important that charging ‘shocks’ are avoided. The publication of indicative charges for at least the next three years will assist in achieving this aim. Significant deviations between indicative and actual charges should be explained.

Question 11

We support interruptible capacity prices being discounted by 100%.

Other comments

The Association considers that this document has been superseded to some extent by GCM01 which may result in the introduction of a transportation model in April 07. If this were the case then any further changes to the methodology would be incremental in nature. We will provide comments to that document separately.

Clarity over the assumptions underpinning the indicative charges would be desirable and a commentary on how prevailing capacity bookings will be reflected in the Ten Year Statement and how this will affect the supply / demand balance beyond 2010.

Looking at GCM01 in conjunction with this document no information is provided on indicative charges for 2008/09 and 2009/10 to assess the impact of the proposed reforms to the NTS exit regime on charges between 2009/10 and 2010/11. Clearly the removal of long term interruptible sites will be expected to have some impact. We note this has been presented at a TCMF meeting, but is notably absent from this document.

This document also suggests that calculated LRMCs will not be adjusted to recover allowed revenue, but does not seek views specifically on this issue. Given that this is a change for the current methodology and would also be a change from the prevailing methodology if a transport model were introduced with effect from 2007 we would expect this issue to be more fully considered. We provide further comments on this in connection with GCD03.

GCD02 – Flexibility Capacity Charges

The Association does not generally support the introduction of the flexibility product, we consider this is a feature of a regime that is required to treat all offtakes the same. A DN will generally need to secure long-term flexibility rights to demonstrate compliance with its safety case and ability to meet 1 in 20 demand, although we do not expect peak flex requirements to co-incide with peak demand. Other direct connects require flexibility in shorter timescales to meet shipper nominations or in the case of CCGTs to meet electricity demand or to provide balancing services to the electricity market. Hence treating all offtakes in the same manner may lead to a loss of diversity of utilisation and may not meet the needs of customers connected to the NTS.

In this context we provide the following comments:

Reserve Prices

We consider that a zero reserve price is appropriate both for long term and daily allocations, since the allocations will release flexibility that exists arising from the current asset base. Signals for further investment to solely provide flexibility are not being sought. We have some concerns that in some zones / regions the incumbent DN will have little competition for flexibility as there are few other offtakes and this might lead to some offtakes obtaining flexibility at very different rates to other offtakes. However at this stage we accept that this is a pragmatic starting point and that this could be reviewed after the first allocations process.

SO Flexibility Commodity Rate

The Association considers that the introduction of this charge element adds unwarranted complexity to the regime. The establishment of a baseline for flexibility has been based on many, many assumptions and is not transparent to the industry, hence using this to apportion SO costs cannot be considered as anything other than arbitrary and it cannot be considered cost reflective. In paragraph 3.12 NG notes the difficulties in accurately assessing the SO cost of flexibility capacity. However we also note that NG considers that it does have a view concerning cost reflectivity with regard to the System Reserve element and that it should be increased by a factor of 10 as one unit of flexibility has ten times the impact of a unit of flat capacity, We consider this needs further consideration as system reserve relates not only to supporting system pressures but also supporting firm exit flows at or around peak periods. As it is generally accepted that peak flex utilisation will not occur at the same time as peak demand then this approach may not be appropriate.

We are also concerned that even if this proposed charge were to pass the 'cost reflectivity' test that its introduction would place an unreasonable cost burden on shippers who supply NTS connected loads. Some may decide not to participate in this market segment or may withdraw. It could create a barrier to entry and therefore not promote competition. This is because we anticipate the cost of developing systems to receive and manage billing quality data to check invoices each day could be substantial. There may also be numerous disputes where internal data is not in agreement with NG data.

Therefore if Ofgem accepts NG's mod 116 as an appropriate way forward we consider that the costs of implementing this charge element and potential for unintended consequences be considered and that the alternative option detailed in paragraph 3.11 be taken forward. This would allow a period of assessment of system operation post DNs sales to assess if behaviours change with any further proposals being based on detailed analysis.

Entry / Exit Split

We support the continuation of the 50:50 split between entry and exit SO commodity charges. However we note that this will introduce further complexity in that there will be three different SO commodity charges all operating at the same time (or even more if GCM03 is introduced) it is not self evident that this complexity enhances cost reflectivity sufficiently to warrant the introduction of the SO (flex) commodity charge.

Under/over recovery

Clearly any charge that is derived using an assumed level of utilisation will contribute to under / over recovery of allowed revenue where the actual utilisation is different from the assumed level. As the amount of gas that enters the system is roughly equivalent to the amount that leaves it seems appropriate to adjust both entry and exit commodity charges equally, absent a flex commodity charge. However the introduction of a flex commodity charge could provide another driver for under / over recovery adjustments which are not related to throughput. Scaling all commodity charges maintains the differentials but could result in movement of revenue between entry and exit or vice versa. It would therefore seem more appropriate to ring fence entry and exit, but this also has other consequences. If the actual utilisation of

flexibility is lower than that assumed then in order to recover the allowed revenue the flat commodity charge will rise. This seems to demonstrate that the proposed flex commodity charge is not cost reflective since if it were, then costs would also fall and it would not be necessary to increase the flat commodity charge, which would seem counter-intuitive and clearly not cost reflective.

GCD03 – Recovery of TO Allowed Revenue

The Association has some concerns that for a discussion paper this document does not consider scaling (either by additive or multiplicative factors) of LRMCs as an option, indeed it only seems to present NG's preferred view. Nor does it explore the consequences on not applying any scaling to LRMCs. This is not to say that the Association currently has a strong view concerning whether LRMCs should be scaled or not, but considers that sufficient information should be provided so that the issues can be fully considered.

We have some sympathies with the concept of not scaling LRMCs as this would mean they are more cost reflective, which in itself is an important principle. However it seems likely that unscaled LRMCs will only recover a fraction of the exit allowed revenue. With the proposal being to recover further revenue via a TO commodity charge, this will lead to the commoditisation of capacity charges. It is this principle that we consider warrants further investigation. We have calculated that in a relatively expensive exit zone a CCGT with a typical load factor of 60-70% will be paying up to one third of its exit capacity costs via a commodity charge. In a cheaper exit zone the fraction rises above 50% and where the exit charge is only 0.0001 p/kWh/day the fraction becomes almost 100%. As throughput is not a constant fraction of peak capacity at all NTS offtakes this will result in a re-distribution of revenue that may not be appropriate nor cost reflective.

NG proposes moving to the use of additive factors to recover allowed revenue in GCM01 in the transitional period but then dismisses the use of scaling if auctions are introduced for exit capacity as part of the enduring regime. It also notes in paragraph 2.4 that the TCMF has recognised that commodity charges for allowed revenue adjustments are more consistent with a regime that includes auctions whilst scaling is appropriate for administered price regimes. NG is also concerned that using capacity prices as a means to manage under or over recovery might distort auction behaviour. Whilst we support these sentiments it is not apparent that the TCMF were presented with all the relevant information in forming this view. It is perhaps a matter for further debate as to the extent the exit regime is an administered price regime or an auction regime. It would not seem unreasonable to expect that the vast majority of NTS exit capacity to form part of prevailing rights and pay an administered price. Where capacity is purchased annually or daily at most offtakes there will be no competition for capacity so it will also be purchased at an administered price as will any incremental capacity. Therefore the key element of uncertainty will be the prices paid for long term flexibility. One approach might be to consider scaling exit charges, by the addition of a fixed amount as proposed in the transitional period, to achieve a certain % of allowed revenue then to use a TO commodity charge to adjust for smaller deviations from allowed revenue. Such an approach may be considered more cost reflective, as it would avoid some of the revenue re-distribution concerns expressed above and reflected in the TCMF progress report paragraph 4.27 at entry when a high TO commodity charge applies. It may also result in more stable charges

overtime when the total capacity related charges are considered, especially since any commodity charge must be set based on an assumption on utilisation which if wrong will also need to be amended for. In extreme this could give rise to more frequent changes in charges so that NG ensures its revenue remains within the appropriate bands around allowed revenue. It is not possible to comment on this further until NG provides some additional analysis and models scenarios that also explore other approaches to recovering allowed revenue so that the advantages and disadvantages might be more fully considered.

If a TO commodity rate is progressed we would support the principle of a 50:50 entry exit split with these ring fenced for the purposes of adjusting for allowed revenue. A collared negative TO commodity charge would also seem to be a reasonable approach as would the approach in the event of an over recovery.

Other issues

The NG preferred methodology is not entirely clear in connection with the how the TO commodity charge would be set and what it would be applied to. Paragraph 4.5 appears to suggest that flat and flexibility utilisation at storage sites would be excluded when calculating the TO commodity charge. It is not clear why this is proposed as the principles imposed by Ofgem following DN sales requires all offtakes to be treated the same, therefore treating storage differently in any aspect of capacity or charging would not be consistent with this principle. (see AEP response to GCM03 for further discussion of these issues in relation to storage)

It is also not clear whether NG's preferred methodology would levy the TO commodity charge on both flat and flexible capacity albeit it discusses this in paragraph 3.11. Clearly there are additional issues of complexity if the charge were to be levied on both products. Also applying a large TO commodity charge on flexibility that is not truly cost reflective may have other consequences including increasing the costs transferred to the electricity market beyond the efficient level; this may distort behaviour and not deliver an efficient interaction between the markets.