RWE npower

Jan Gascoigne
Regulatory Frameworks
National Grid
National Grid House
Gallows Hill
Warwick CV34 6DA

Your ref NTS GDC01-03
Our ref
Name Stephen Rose
Phone 01793 892068
Fax 01793 892981
E-Mail stephen.rose@rwenpower.com

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NTS GCD01 - Introduction of NTS Exit (Flat) Capacity Charges under the enduring offtake arrangements
NTS GCD02 - Introduction of NTS Exit (Flexibility) Capacity and Commodity charges under the enduring offtake arrangements
NTS GCD03 - Recovery of TO Allowable revenue from Exit Users from 1st October 2010

Dear Jan,

RWE npower welcomes the opportunity to comment on the above pricing discussion papers and does so on behalf of all its retail gas shipping/supply businesses and RWE Trading GmbH (RWET).

Throughout our response references to capacity and flat and/or flexibility capacity refer to NTS Exit Capacity, unless otherwise stated.

NTS GCD 01 - Introduction of NTS Exit (Flat) Capacity Charges under the enduring offtake arrangements

The issues raised within this discussion paper have been discussed and developed at Transmission Charging Methodology Forum (TCMF) and have to a large extent been superseded by pricing consultation NTS GCM01 - Alternative Methodologies for Determination of NTS Entry and Exit Capacity Prices.

It is our intention to respond fully to NTS GCM01 in due course but in the meantime we would make the following comments with regard to the options contained within this discussion paper.

We support the introduction of a transportation model to set flat capacity charges under the enduring offtake arrangements as opposed to retaining the Transcost model. Whilst no model will be able to exactly determine the actual flows of gas on the system, or precisely calculate the long run marginal costs arising from such flows, we believe that moving towards a transportation model will provide users with greater transparency and predictability of charges that have otherwise been largely opaque to them.

Transcost relies heavily upon the subjective assessments of network experts to calculate capacity prices and as a consequence produces results which are not always repeatable. In some cases, due to assumptions which have been made, results are

RWE npower

Trigonos
Windmill Hill Business Park
Whitehill Way
Swindon
Wiltshire SN5 6PB

T +44(0)1793/87 77 77
F +44(0)1793/89 25 25
I www.rwenpower.com

Registered office:
RWE Npower plc
Windmill Hill Business Park
Whitehill Way
Swindon
Wiltshire SN5 6PB

Registered in England and Wales no. 3892782

also counter intuitive. Whilst this may be a feature of a transportation model too, we believe this is likely to occur to a lesser degree.

In the long run a transportation model is likely to generate more consistent and stable flat capacity prices than Transcost and these prices will hopefully lead to a greater recovery of incremental investment costs.

Due to the inherent uncertainty associated with predicting gas demand and supply flows as the UK becomes more import dependant and as the requirement for gas generating capacity increases, we do not believe it is credible to continue to base flat capacity prices on a 10 year forecast of future demand/supply. Moving to a one year demand/supply forecast will ensure that charges are at all times based on an accurate reflection of supply and demand on the network at the time they apply. Whereas this may, in certain cases, lead to differences arising compared to prices currently being charged (due to the lack of re-balancing over the years and the loss of the smoothing effect resulting from annuitising 10 years of charges) this impact should be predictable, and charges should be more justifiable under such an approach. Such an approach also supports any user commitment that is required to be given to underpin incremental investment in prevailing capacity being based on capacity prices prevailing at the time of delivery and ongoing operation.

Whilst excluding spare capacity from a transportation model is clearly an assumption which does always reflect network reality (particularly when using a single year supply/demand network model) we believe that it is a reasonable assumption to make. In our opinion it will result in prices which are a reasonable proxy of fully cost reflectivity bearing in mind that pipeline capacity can never be sized to exactly match incremental requirements or de-commissioned to reflect redundant demand.

Similarly we believe that including backhaul benefit equal to the avoided cost of reinforcement is an appropriate assumption to make if spare capacity is excluded.

National Grid NTS (NG) demonstrated at TCMF that using a reference node and where that reference node located is irrelevant to the level of capacity costs (entry and exit), and is used simply to disaggregate route costs into entry costs on a 50:50 basis. To this extent this concept appears consistent with the assumptions regarding excluding spare capacity and including backhaul benefit.

With regard to the features common to the two options, we agree that it is appropriate to use the annuitisation factors in NG's licence to convert LRMCs into charges, where necessary, and that interruptible capacity charges should be discounted by 100%. We also accept that year on year capping of flat capacity prices is no longer appropriate provided the model proves to be as user friendly and predictable as indicated, and provided that where material deviations arise between forecast and actual prices these are explainable.

As regards setting prices for all NTS Exit points at nodal level as opposed to Exit Zone level (in the case of DN Offtakes) whilst we support this approach in principle we are concerned that this could lead DNs to fundamentally re-appraise how they pass on the costs of NTS capacity to their LDZ connected customers. Any move away from charging LDZ connected customers based on their LDZ Exit Zone will have a material impact on shipper/supplier registration and billing systems. Before accepting such an approach therefore we would welcome an early view from DNOs about how such an approach is likely to impact on how they intend to pass on such charges.

<u>NTS GCD02 - Introduction of NTS Exit (Flexibility) Capacity and Commodity charges under the enduring offtake arrangements</u>

Despite RWET raising an alternative to NG’s modification proposal 116 which retains the principle of unbundling flat and flexibility capacity we do not support such an approach. Unbundling these two

components will, in our opinion, create an unwarranted degree of complexity for all market participants and is being proposed purely as a result of Ofgem/NG's desire to treat all offtakes equally. In reality however NTS offtakes have very different reasons and requirements for flexibility capacity. Simply ignoring this fact is likely to lead to a loss of diversity and less efficient system operation a whole.

RWET's alternative modification proposal 116B suggests that if unbundling is to be imposed on market participants certain aspects of how this is implemented should be amended. Included within this is a proposal not to include provision for a SO flexibility commodity charge within the UNC, as doing so will require users to build greater complexity into their gas management and billing/settlement systems than would otherwise be the case.

With this in mind we would make the following response to the questions raised in this discussion paper.

Throughout the discussions that have taken place on a dis-aggregated flexibility product it has generally been accepted that the NTS has made no investment decisions specifically with a view to providing flexibility capacity. It has also been accepted that it would be significantly more costly for the NTS to provide incremental flexibility capacity compared to the cost of DNs providing flexibility capacity through diurnal storage. On this basis it would seem appropriate for any flexibility capacity sold in annual and/or daily auctions to have a zero reserve price, despite the fact that it largely exists as a by product of flat entry and exit capacity investment.

It is also logical for flexibility capacity reserve prices to be the same regardless of the availability of flexibility capacity within a zone/area.

We do not accept NG's logic for introducing a SO flexibility commodity charge and do not believe this can be calculated in such a way as to be a sufficiently accurate proxy for cost reflectivity.

In our opinion the absence of a SO flexibility commodity charge, or setting such a charge at zero, is unlikely to alter parties behaviour as NG suggest. It is noticeable that no evidence has been presented of any change in parties behaviour since DN sales took effect, during which time utilisation of flexibility capacity has not been charged for. DN use of flexibility capacity will be governed principally by the need to meet demand and pressure requirements on their networks whereas direct connects will use flexibility capacity as dictated by the circumstances of the market they operate in. For example, a gas fired power station is not going to use more flexibility capacity than it otherwise would simply because a charge is not applied, as its operation will be largely dictated by the gas electricity spark spread. This is particularly so if the commodity charge is expected to be low.

Any incentive on DNs or direct connects to alter their use of flexibility capacity will arise from their potential exposure to flexibility capacity overrun charges not from setting a positive SO flexibility commodity charge (which may or may not be cost effective).

We see no logic in introducing a SO flexibility commodity charge on the grounds that once unbundled flexibility utilisation requires its own commodity charge so as to be consistent with other entry and exit capacity products. This is particularly so bearing in mind the difficulty NG have in accurately identifying what SO costs are incurred as a result of using flexibility capacity, and how much flexibility capacity is likely to be available on any one day.

Whilst it is probably true that "at the extreme if there was no flow profiling across the NTS, SO costs would be lower" NG's analysis fails to recognise that profiling takes place at entry as well as exit. Allocating an assumed 50% exit percentage to aggregated annual SO costs and pro rating these based on a notional flexibility capacity baseline when the availability of flexibility capacity may have arisen as a consequence of entry profiling (which is not charged for), highlights the inherent difficulty in coming up with a methodology which is a reasonable proxy for cost reflectivity.

Knowing the difficulty NG had in arriving at their notional baseline flexibility capacity figure of 22 mcm/d and the various assumptions that were made in the process, and bearing in mind that on most days the amount of flexibility capacity that could be released is likely to be in excess of 22 mcm/d, it could be argued that the proportion of system reserve costs apportioned to flexibility utilisation should be higher, and the proportion of other SO costs should be lower on most days during the year. Alternatively one could argue that the proportion of SO costs attributable to flexibility utilisation is likely to be driven by actual utilisation, rather than by a notional baseline flexibility capacity. As annual usage is likely to be significantly less than the annual aggregate of the daily baseline (as indicated in the indicative SO flexibility commodity charge included in the document) perhaps the opposite should be the case.

An inevitable consequence of introducing a SO flexibility commodity charge will be over or under recovery of forecast revenue. Maintaining initial price ratios between the three SO exit commodity charges has some merits in terms of simplicity and probably represents the least worst option, although we doubt whether this will result in greater stability and certainty of these charges as a whole. Whilst this may lead to the revenues from flexibility capacity utilisation not equalling their target this is of little relevance if the SO flexibility commodity charge that drives the target revenue bears little resemblance to the actual costs incurred.

NTS GCD03 - Recovery of TO Allowable revenue from Exit Users from 1st October 2010

NG's arguments as to why they think it inappropriate to continue scaling capacity charges to recover the exit proportion of allowed TO revenue are not entirely clear to us. Presumably this is based on the assumption that once auctions are introduced scaling to LRMCs, which form the basis of auction reserve prices and prevailing rights capacity charges, promotes efficiency and competition between shippers and avoids undue preference in the supply of transportation services.

In the case of flat capacity, which we assume will recover the vast majority of the allowed TO exit revenue, auctions will held on a nodal basis annually for constrained capacity and daily for unsold baseline and interruptible capacity. In the case of flexibility capacity, auctions will be held annually for baseline capacity, although as these will have a zero reserve price scaling is not an issue (the same applies to interruptible flat capacity auctions).

As users will be allocated an initial level of prevailing flat capacity equal to their current firm/interruptible booking and as flat capacity is sold nodally, we would be surprised if auctions for flat capacity make more than an token contribution towards allowed TO exit revenue. Whilst some users may choose to profile their flat capacity holdings and purchase this via the daily or annual auctions, we suspect this to occur only at a small number of high priced offtakes. This is because of the administrative burden arising from procuring flat capacity at multiple offtakes capacity on a daily basis, the lack of a discount in reserve price for daily flat capacity and the risks that would arise from NG's substitution obligation.

We believe that scaling may still be appropriate despite the introduction of flat capacity auctions and believe this should be given further consideration.

NG's proposal not to scale LRMCs could lead to under recovery of allowed TO exit revenue irrespective of the contribution of auctions and replicating under/over recovery provisions that currently exist at entry into the exit regime will give rise to yet another commodity charge being introduced.

As at entry such a charge could be inherently volatile and could have the effect of commoditising capacity charges. In the event a SO storage commodity charge is introduced (as proposed in pricing consultation GCM03), this could result in five distinctive commodity charges being applied (or effectively seven if SO and TO exit commodity charges are levied on both offtake and flexibility utilisation) once the enduring offtake arrangements take effect. This would be a sad indictment of the efficiency of the overall

NTS charging methodology under price control restrictions.

We support recovery of exit buy back costs through an exit capacity neutrality mechanism as we believe this will lead to better targeting of cost and revenues. However, under RWET's modification proposal 116B, we have argued that rather than having one overall pot that is smeared back solely on the basis of a users flat capacity holding there should be separate flat and flexibility capacity neutrality pots, as this will enhance cost targetting.

Negative TO exit commodity charges would have to apply in the event of over recovery and it would seem sensible for these to be collared to prevent the aggregate of TO and SO exit commodity charges being negative.

We support setting TO exit commodity charges at a level which when combined with exit capacity charges (flat and flexibility) recovers 50% of the allowed TO revenue. However, we do not support a TO exit commodity charge being levied on flexibility utilisation for reasons stated in GCD02 above, particularly as the cost of providing flexibility capacity has historically been zero and that no new investment in flexibility capacity is expected to be made by the NTS.

Should you wish to discuss any of the points raised above please do not hesitate to contact me.

Yours sincerely,

Steve Rose
Economic Regulation

Sent by e-mail and therefore not signed