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Dear Julian

**Modification Proposal 0090: Revised DN Interruption Arrangements**

Thank you for providing SGN with the opportunity to comment on the above Modification Proposal. Whilst the Proposal has been raised by National Grid UKD, it has been developed with the support of all Distribution Network Operators (DNOs) in order to fulfil the reasonable endeavours obligation set out in Standard Special Condition D8 (Reform of Distribution Network interruption arrangements) of our Gas Transporter licence. However, for the reasons set out below, we are unable to support the implementation of this Modification Proposal at this stage.

Modification Proposal 0090 has been developed in response to Standard Special Condition D8 and has taken into account comments made during the various Ofgem consultations and industry discussions on this subject and builds on the framework established during the DN sales process. To that end, we believe it addresses Ofgem's perceived weaknesses associated with the current regime and meets the objectives previously outlined by Ofgem. However, SGN firmly believes that the Modification Proposal is just one aspect of the wider package of reform, the other aspects of which have yet to be addressed and accepted by both the relevant licensees and Ofgem. For example,

1. Ofgem is currently consulting on the Gas Distribution Network price control review and DNO incentive arrangements associated with DN interruption and NTS exit reform. The satisfactory outcome of this consultation process and subsequent licence drafting is critical for SGN to ensure that it is not exposed to contractual obligations with Users for interruption rights and/or reinforcement capital expenditure with no means of appropriate cost recovery.

2. As part of the above consultation process, Ofgem is also seeking views on how best to treat potentially high contractual costs of interruption and/or system reinforcement costs specifically associated with Network Sensitive Loads (NSLs) located on the DNO's networks. As with point 1. above, this is a critical issue that must be resolved to ensure that the DNOs are not exposed to the potentially high costs associated with managing these loads under the proposed reform.
3. In parallel, Ofgem has also issued an impact assessment to help identify the costs and benefits associated with implementation of DN Interruption reform. At this stage, we do not believe there is a complete understanding of the potential consequential costs of implementing the reform and therefore at this stage, we are not in a position to say whether, in our view, the Modification Proposal categorically better facilitates the relevant objectives.
4. In order to implement the Modification Proposal, the DNOs will need to develop and have "approved" by Ofgem an Interruptible Capacity Methodology to enable it to contract with Users of the DNO's system for interruption rights. As yet there is insufficient information to allow DNOs to develop this Methodology meaning there is still considerable uncertainty around this aspect of the proposed framework.

5. Finally, DNO's safety cases will need to be amended alongside any proposed reforms. This process will need to be managed between the NTS and DNOs in a coordinated manner given the interactions between NTS exit reform and DN interruption reform. This process is only at the very early stages and will be dependent upon the outcome of the consultation process.

Clearly it is vitally important that each of the above aspects of the proposed reform are considered in full and in the context of the whole package of reform to ensure that they are addressed and satisfactorily resolved prior to the implementation of any Modification Proposal. It is essential that reform delivers tangible incremental benefit and allows DNOs to recover all reasonably incurred costs associated with implementing and operating the new regime. Accordingly, SGN will respond to the other consultations in turn, however at present given the critical nature of these other considerations as to the suitability of the proposed Modification Proposal, SGN is not able to give its support to the Modification Proposal at this stage.

If the outcome of each of the above issues is resolved satisfactorily and DN interruption reform is to be taken forward as envisaged by Ofgem, we believe that Modification Proposal 0090 is the most efficient way forward. Accordingly, we have provided our comments on the Draft Modification Report in the attached document. The first part of our response provides general comments in relation to Ofgem's principles and objectives for reform. The second part of our response addresses the specific questions detailed in the Draft Modification Report.

Yours sincerely

Beverley Grubb  
Commercial Manager

## **SGN's Detailed response to Modification Proposal 0090**

### **Background**

In March 2001 Ofgem published a review of Transco's NTS exit capacity, interruption and LNG arrangements. The paper set out perceived weaknesses associated with interruption arrangements and set out proposals for reform. Following further industry discussion, in May 2003 Ofgem determined that the programme for reform was to be rescoped to include DN interruption arrangements. Interruption reform was subsequently identified as one of the "gateway" issues for the sale by National Grid of the four distribution networks, consequently a framework was developed as part of the DN Sales regime and Standard Special Condition D8 was introduced into the DNO's licence in May 2005 placing a reasonable endeavours obligation on DNO to review and develop proposals for interruption reform by 1 April 2005 or, as soon as reasonably practicable thereafter. It then became clear that there were difficult and important interactions between NTS offtake reform and DN interruption reform that were not possible to address within the proposed timetable. Accordingly, in July 2005 Ofgem issued a letter to the industry setting out a revised timetable for the implementation of these arrangements from April 2006 to April 2007.

In response to that revised timetable and mindful of the licence obligation, National Grid UKD, with the support of the other DNO's, developed Modification Proposal 0090. Throughout the development stage, SGN along with the other DNOs have indicated to Ofgem on a number of occasions the importance of addressing other issues such as the price control and incentive implications at the same time as developing the UNC proposals.

### **Ofgem's Concerns Regarding Current Regime and Principles for Reform**

In May 2006, Ofgem issued a consultation document "Initial thoughts on the reform of interruption arrangements on gas distribution networks". That document underpins the proposal set out in Modification Proposal 0090.

In the May 2006 document Ofgem identified what it perceived to be key weaknesses associated with the current regime. They include:

- GDNs lack of control over the amount and location of interruptible capacity.
- Interruption services currently exceed Transporters' requirements.
- No clear investment signal are provided as customers can currently switch between firm and interruptible status at one years notice and provide no details of cost of interruption to allow the DNO to make efficient trade-offs.
- Lack of flexibility in the interruption services offered (standard 45 day interruptible product).

Ofgem also set out principles for reform:

- Allow DNOs to determine the amount, type and location of interruption services.
- Provide for clear and efficient investment signals (at least 3 years ahead).
- Reduce the scope for undue discrimination between existing and new customers for capacity allocation and interruption.
- Promote competition in the provision of interruption services, potentially reducing costs to DNOs when purchasing interruption.

At this time and in the absence of a conclusion on each of the five issues identified above, SGN believes that **if** DN interruption reform were to proceed, Modification Proposal 0090 would address all of the above Ofgem perceived weaknesses and deliver each of Ofgem's principles of reform. Against this background, detailed comments on Modification Proposal 0090 are presented below.

### **DNOs Determine Amount and Location of Interruption**

Under Modification Proposal 0090 DNOs will determine the amount of interruption required on a locational basis, taking account of the dynamics and operational needs of individual networks. Requirements will be communicated to Users ahead of the tender process. Users will be free to determine whether they are willing to offer interruption services in the locations required and will have time to determine the basis on which such services will be offered. We believe such arrangements could improve transparency for Users and potentially increase efficiency. By ensuring Users have a better understanding of interruption requirements they should be able to tailor services accordingly to reflect individual capability and costs. DNOs might then be better placed to match bids against needs to secure the most economic and efficient outcome. However, it will also be vital to ensure that reform does not result in

otherwise unnecessary investment to meet presently interruptible loads. The treatment of, for example, Network Sensitive Loads and the price control incentive framework therefore need to be resolved, before we can be sure that the possible benefits might materialise.

### **Interruption Services Currently Exceed Transporters' Requirements**

Whilst it is true that under current arrangements DNOs have no control over the amount or location of interruption, such services are currently taken in to account when determining investment requirements. As such all interruption currently provides a service and has a value to DNOs. It is misleading to assume that interruption services currently exceed all aspects of a Transporters requirements and therefore inefficient. All sites would be required to be interrupted in order to meet 1 in 20 conditions, but it is unlikely that all sites would be required for the full 45 days of interruption. Under Modification Proposal 0090 DNO's interruption requirements will be more specific. Users will be able to tailor their bids. Greater flexibility in interruption services offered could help avoid any potential for over contracting for interruption, particularly in relation to the number of days of interruption per site.

It should be noted that some Users have indicated that the added complexity of such arrangements could result in fewer sites tendering for interruption. Others have indicated that following detailed analysis, cost reflective charges may result in additional payments being required for interruption, above discounts currently offered by DNOs against firm transportation charges. Whilst the new regime may be more robust, if this were the case it may not be lower cost and therefore this point must be considered carefully when addressing the cost benefit analysis of the proposed reform and the price control implications.

SGN believes that as new arrangements will provide DNOs with a market based signal of the cost of interruption, even if additional payments are required, the process shall be more robust. Providing payments are in general the least cost option, and below alternative investment costs, interruption costs incurred by the DNOs must be deemed to be efficiently incurred and therefore fully recoverable.

### **Investment Signal**

The Modification Proposal allows DNOs to contract 3 years ahead for interruption services and for periods of up to 5 years. Provisions have also been inserted for Ad-hoc auctions to allow DNOs to fine tune their requirements. Under the proposed DN interruption reform framework, we believe the proposed contract period would help improve the efficiency of the planning process as DNOs could have a clear picture of capacity requirements and interruption services available to them over the planning horizon. Assuming Users offer services over the full duration, this could mean that DNOs will be better placed to make economic and efficient trade-offs between investment in their own network, purchase of NTS/LDZ offtake capacity and purchase of interruption services. However, as stated above, it will be necessary to ensure that the price control components allow the recover of costs of resultant investment and for the arrangements to address legacy issues such as NSLs.

Following discussion within the Development Work Group and consideration of responses to the Pricing Discussion Paper, it is SGN's intention that in the event that the proposed framework of reform is implemented, interruption services will be secured through a tender process with Users determining the level of payment to be offered in return for interruption services. SGN believes this could provide a clearer signal of the value of interruption to Users, which will then be compared against the cost of investment or purchase of NTS/LDZ offtake capacity to enable DNO' to determine the most economic and efficient outcome. However, the benefit of this must be assessed against the cost of possible (substantial) additional investment.

A number of Users have indicated that they would not be willing or able to determine costs so far out and would not be willing to contract over such a long timescale. If the market response is poor, there is a risk that the full perceived benefit of reform may not be realised and substantial investment triggered to meet firm loads. . As we have indicated above, this will need to be carefully considered as part of the cost benefit analysis being undertaking by Ofgem.

### **Flexibility in the Interruption Services Offered**

Modification Proposal 0090 allows Users to offer services on a locational basis for time periods of up to 5 years. Users will be free to select the number of days of interruption offered within a framework specified by DNOs. It will be up to the User to determine the

payment required for such services and how such payment should be allocated between a monthly Option Fee payable in equal amounts over the entire duration of the contract and an Exercise Fee, payable following interruption. SGN believes this provides considerable flexibility to Users to structure their bids to reflect the services they are able to offer and the costs they are likely to incur.

### **Reduced Scope for Discrimination Between Existing and New Customers for Capacity Allocation and Interruption**

Under Modification Proposal 0090 all Users will effectively be treated as having firm DN capacity rights and will be liable to pay the corresponding transportation charges. Providing they meet the criteria set out under the proposal, eligible Users will then be able to participate in a tender process and offer interruption rights to DNOs. Selection of interruption services will be in accordance with principles set out in the Interruptible Capacity Methodology Statement. As such SGN believes arrangements are equitable, ensuring equal treatment for all existing and new customers.

Arrangements have been developed to take account of new loads and as far as possible they will be treated in the same way as existing customers. Proposals accommodate circumstances where a DNO's ability to meet a User's requirements may be restricted in the short term. As such interruption rights may be mandatory for a specified period, until the customer can be connected as firm.

### **Extent to which implementation of the proposed modification would better facilitate the relevant objectives**

- As we have indicated at the beginning of this response, there are a number of significant aspects of the proposed framework of reform that have yet to be addressed, and therefore, at this stage it is difficult to assess whether the Modification Proposal would better facilitate the relevant objectives. Nevertheless, as far as possible, arrangements have been developed to strike a balance between simplicity and flexibility whilst securing the most economic and efficient outcome in transportation arrangements. However the proposed arrangements do introduce some additional complexity compared to the existing framework. In some cases this may deter customers and Users from participating. It is also possible that arrangements may result in an increase in the cost of interruption. Were this to occur, DNOs could be forced to pay more for access to interruption or invest in some locations. Some participants may argue this is to the detriment of customers and can not be considered to be more economic or more efficient. SGN believes that it is essential that such issues are fully explored in the impact assessment currently being conducted by Ofgem. However, if DN interruption is to be adopted, we believe that the arrangements set out in Modification Proposal 0090 represent the best available model.

### **Implications of implementing the Modification Proposal on security of supply, operation of the Total System and industry fragmentation**

In relation to security of supply, the Workgroup did recognise that reform could have a detrimental impact on security of supply to the extent that it leads to a reduction in the number of interruptible sites available to DNOs. If this were the case there could potentially be more rapid escalation to Stage 3 in a Network Gas Supply Emergency.

In terms of operation of the system, SGN does not believe there are any direct implications for operation of the system. Systems would continue to be operated as they are now.

In relation to industry fragmentation, SGN believes the proposal will maintain the status quo, with the same framework applying to all DNOs.

### **Implications for Level of Contractual Risk of Transporters, Shippers and Customers**

SGN believes that implementation of modification Proposal 0090 should reduce the level of contractual risk for all participants as Users should have a clearer understanding of DNO's requirements. Contracted levels of interruption should meet Transporters requirements and customers should have a better understanding of the likelihood of interruption. Also Users would be free to determine terms on which they would be willing to offer services and they should better reflect actual costs.

As stated above, there is a risk that Users will not be willing to offer interruption services under the new regime or that the cost will be prohibitive. DNOs may have to invest to meet capacity requirements.

During Work Group discussions Shippers and consumer representatives expressed concern regarding the duration of contracts. There was concern that this could create complexity and increase risk, particularly in relation to the change of Shipper process as incoming Shippers may not have sufficient knowledge of interruptible terms to be able to bid.

SGN believes that as far as possible, such risks have been taken into account in developing proposals, and that a reasonable balance has been struck in trying to reduce complexity which improving transparency and efficiency of arrangements.

### **Indication of Areas of UK Link System Likely to be Affected**

To be completed

### **Implications for Transporters**

#### **Development and capital costs and operating cost implications**

Details are still being considered and will be submitted in response to Ofgem's consultation "Reform of interruption arrangements on gas distribution networks – an update".

#### **Most appropriate way to recover the costs**

SGN believes that to the extent that DNOs can demonstrate that implementation and ongoing costs have been efficiently incurred they should be recovered through the price control process.

As stated above, it should not be assumed that reform will automatically result in a reduction in costs. However under the Ofgem's proposed framework it is understood that if the costs have been market tested, and are below the alternative investment cost, they would be deemed to have been efficiently incurred. Clearly, it is critical that this aspect of the proposed reform is clearly understood prior to the implementation of any Modification Proposal and we note that discussions are ongoing as part of the Gas Distribution Price Control Review and incentive arrangements.

#### **Consequences (if any) for price regulation**

We have already indicated that it will be essential to ensure that all efficiently incurred costs associated with the implementation of the proposed reform and the purchase of interruption rights and/or alternative investments are included in the DNO's allowed revenue calculation. At this time price control discussions associated with DN interruption reform, including locational market power of existing NSLs and any incentive arrangements remain outstanding. Therefore, until these issues have been resolved satisfactorily SGN cannot support the implementation of Modification Proposal 0090.

Notwithstanding the above, it is apparent that the costs associated with interruption rights will need to be reflected in Transporters' transportation charging methodologies. Correction mechanisms will be essential as it is likely that the cost of interruption services will be difficult to predict and highly variable year on year, as we move to a market based tender process, with customers determining payment levels for interruption services.

SGN would also note that there are important interactions with NTS Offtake reform. As far as possible these have been taken into account; however the proposal has been based on existing arrangements. We believe that the proposals would complement NTS Offtake reform, were it to be implemented by Ofgem. However some amendments may be required, to the extent that investment lead-times, capacity booking application windows etc associated with the proposed NTS exit reform arrangements are subsequently incompatible with aspects of the Modification Proposal as currently drafted.

Changes would also be required to SGN's Safety Case. This is being progressed by SGN.