



Modification Panel Secretary
Joint Office of Gas Transporters
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Dear Julian

Modification Proposal 0116V/0116VA/0116VB/0116VC/0116VD: Reform of the NTS Offtake Arrangements

SGN welcomes the opportunity to comment on the above Modification Proposals.

Ofgem have made it clear that exit reform should be implemented and this is reflected in the obligations set out in Standard special condition A55, requiring Transporters to use their best endeavours to implement enduring offtake arrangements in a form approved by the Authority. In addition, there are a number of aspects of the transitional regime that we do not believe are sufficiently robust for the enduring regime. For example, SGN has concerns regarding the arrangements for allocating NTS Exit (Flexibility) Capacity. National Grid NTS has repeatedly expressed concern that NTS Exit (Flexibility) Capacity will become increasingly constrained. Were demand to outstrip supply, we do not believe that the transitional arrangements would provide the level of transparency required or ensure capacity would be allocated in the most economic or efficient manner.

As a consequence, of the alternatives presented, while we have serious concerns about the complexity of Ofgem's policy in this area, SGN believes that Modification Proposal 0116VD has the greatest potential to achieve the relevant objectives of reform, particularly in relation to the economic and efficient operation of the network. SGN does not support Modification 0116VA, 0116VB, 0116VC or 0116V.

Compared to the alternatives, Modification Proposal 0016VD provides NTS with a clearer picture of credible User requirements, taking account of both positive and negative flexibility requirements, a User's controllable requirements and allows DNO Users to take account of diversity across offtakes in relation to NTS Exit (Flexibility) Capacity. This should help ensure all Transporters can plan and manage their system in the most economic and efficient manner. It also provides Users with the level of commitment they require to manage their operations.

While SGN do not support any of the alternatives, we have no objection in principle to Shippers and directly connected customers not being party to the enduring arrangements.

SGN is also mindful of the fact that the Modification Proposal is just one aspect of reform. At this point in time, other key aspects are still being considered by Ofgem or being consulted upon. It is apparent that implementation could result in significant additional risk and cost to the industry, in terms of initial implementation and ongoing operation of the arrangements. Ofgem has recently issued a consultation document and is seeking views on potential costs and benefits to the industry. SGN believes that it is essential that all potential costs, including those associated with additional risk are considered, not just implementation costs. We note

that NTS is also consulting on charging arrangements. We look forward to receiving more detail in due course.

Background

Reform of NTS offtake arrangements follows years of industry discussion and consultation. The above Modification Proposals builds on proposals further developed during the DN sales process.

In its decision to allow the sale of gas distribution networks to proceed, the Authority concluded that the sale would fundamentally change the structure of the gas industry and that changes were required to the regulatory, commercial and operational framework to take account of the multiple network owners. In Ofgem's November 2005 Final Impact Assessment document, the Authority concluded that changes were required in three key areas:

- roles and responsibilities of network owners
- centralisation of services
- offtake and interruption arrangements.

All three areas were deemed to be gateway issues and were initially to be delivered before the sale could proceed. However in recognising the complexity of the issues to be addressed in relation to offtake and interruption reform, the timescales were revised by Ofgem. Offtake and interruption reform was delayed and arrangements were further developed out with the DN sales process, under the direction of Ofgem.

The principles established by Ofgem for NTS offtake reform have been well documented and are outlined in the Authority's November 2005 Final Impact Assessment document. They are that arrangements should:

- recognise the new interfaces between network owners;
- ensure equality of treatment between all Users (DNO Users and Shipper Users)
- ensure all Users have equal access to offtake rights, released on the same basis;
- in the long run (unconstrained period) offtake rights are to be unlimited, providing Users are willing to provide financial commitment and provide signals within timescales required by NTS to carry out investment;
- rights are to be "guaranteed" by NTS;
- if NTS fails to deliver, Users will "receive compensation" from NTS;
- the price associated with offtake rights in the long run is to be regulated;
- in the short term (constrained period) offtake rights will be limited to network capability.
- In the short term Users will compete to gain access and arrangements must ensure capacity is allocated in a "non-unduly discriminatory fashion".
- arrangements should provide for NG to contract to buy back capacity if it believes it would be economic to do so.

Whilst it has recently been determined that it is not efficient for NTS to invest to provide additional NTS Exit (Flexibility) Capacity, the principle that a level playing field should exist still applies and Ofgem has indicated that Users should be able to compete on a common basis.

DN Requirements

From a DN perspective, SGN believes it is essential that reform should provide a mechanism that will allow:

- Users to understand system capability and costs in the long, medium and short term to allow them to assess alternatives and determine the most economic and efficient course of action.
- DNO Users must be able to signal and secure capacity requirements over a period of at least 5 years, to allow them to plan and manage their networks to meet obligations, whilst taking account of investment lead times.
- Long term capacity requirements must be guaranteed by NTS, with appropriate incentives or liabilities where NTS fails to deliver as there are likely to be significant consequences for DNO Users and limited or no alternatives once within investment lead times.
- Capacity must be allocated in a transparent and non-discriminatory manner. For the avoidance of doubt this does not mean that arrangements must be the same for all classes of Users.

SGN recognises that the main area of concern amongst a number of participants, particularly Shipper Users, relates to the release of NTS Exit (Flexibility) Capacity. A number of the alternative Modification Proposals propose transitional NTS Exit (Flexibility) Capacity booking arrangements should be retained. SGN are aware that there are short comings with the

transitional arrangements which are likely to become more acute should demand for NTS Exit (Flexibility) Capacity increase and the product become increasingly constrained, as suggested by National Grid NTS. SGN is concerned that the transitional arrangements do not provide sufficient transparency in terms of capacity availability and where demand outstrips supply, we are concerned that the arrangements are not sufficiently robust to ensure capacity is allocated in the most economic or efficient way possible, across DNO Users.

We have no issues with Shippers being subject to the current arrangements. However, the current framework does not address issues concerning DNO Users (particularly the availability and guarantee of the flexibility product, as well as a fairer pressure commitment and tolerance). However, we do not believe Modification Proposal 0116VA or 0116VC meet the key principles of reform therefore SGN does not support Modification Proposal 0116VA or 0116VC. In principle we are not opposed to different treatment for different classes of User. As a consequence, we would not be opposed to a variant on Mod 116VD which removed Shipper Users from the enduring arrangements, but we note that none of the variants achieve this.

In summary, SGN ranks our support for the above proposals in the following order (most supported first):

- Modification Proposal 0116VD
- 0116VB
- 0116V
- 0116VC and 0116VA

Extent to which implementation of the proposed modification would better facilitate the relevant objective.

(a) the efficient and economic operation of the pipe-line system to which this licence relates

SGN believes that Modification Proposal 0116VD, 0116VB and 0116V could facilitate the above relevant objective by providing a robust mechanism for:

- NTS to signal system capability
- Users to signal requirements over appropriate time frames, taking account of system capabilities and alternative options available to Users.

This would improve NTS's ability to plan and invest to meet requirements as economically and efficiently as possible, as requirements should be more specific and tailored to Users' needs, particularly in relation to NTS Exit (Flat) Capacity, although we remain concerned about the complexity of Ofgem's policies in this area.

DNO Users would be able to assess requirements taking into account diversity across their networks and other options such as interruption or investment on their own network. However SGN notes that National Grid NTS has indicated that it may have to raise a further Modification Proposal to amend the timing of the Prevailing booking process to take account of investment lead times. SGN believes it is essential that DNs are able to tender for interruption reform ahead of submitting capacity bookings in order to maximise efficiency.

SGN believes the efficiency of arrangements for release of Prevailing NTS Exit (Flat) Capacity, would be further improved under Option 2 as set out in the ExCR consultation document as Users would understand the level of financial commitment required at the time they make the booking. This would allow them to make a more informed financial assessment of the alternatives available to them at the time of making the booking. Under Option 1, it would be very difficult for DNO Users to determine the most efficient option as the level of financial commitment required would not be known. SGN believes this is inappropriate and unnecessary.

It has been determined that it would not be efficient to invest to provide additional NTS Exit (Flexibility) Capacity, as such Modification Proposal 0116V, 0116VD and 0116VB focus on releasing existing capacity on a transparent and non-discriminatory basis to those that value it most through pay as bid auctions. The arrangements provide for release over a period of up to 5 years. SGN believes arrangements under all 3 proposals could facilitate the economic and efficient operation of the NTS, providing a signal of short, medium and long terms requirements, taking account of diversity across offtakes and ensuring clear commitment on the part of NTS.

SGN does not believe that Modification Proposals 0116VA or 0116VC better facilitate the efficient and economic operation of the pipe-line system. By removing the arrangements

relating to the release of NTS Exit (Flexibility) Capacity we believe there would be no transparent or efficient means for DNO Users to signal changes in long term NTS Exit (Flexibility) Capacity requirements (whether an increase or decrease).

(b) the coordinated, efficient and economical operation of (i) the combined pipe-line system and /or (ii) the pipe-line system of one or more other relevant gas transporters

SGN believes that Modification Proposal 00116VD best facilitates the above relevant objective of the alternatives available.

Modification Proposal 0116V, 0116VB and 0116VD would allow DN Users to make an informed decision when considering capacity requirements, taking into account availability and cost of securing NTS Exit Capacity, cost of securing interruption on its own network and investment on its own network, over timeframes required for planning and investment. However Modification Proposal 0116V fails to take full account of a number of planning and operational considerations which we believe introduce unnecessary inefficiencies for DNO and Shipper Users. SGN has raised Modification Proposal 0116VD to address our most significant concerns. We have commented on these below.

Operating Tolerances Relating to NTS Exit (Flexibility) Capacity

Users (particularly DNO Users) have repeatedly argued that transitional and proposed enduring commercial arrangements fail to take account of operational realities on the network in relation to the NTS Exit (Flexibility) Capacity product. A tolerance of 1.5% barely takes account of measurement inaccuracies and fails to take any account of the physical realities of the network. Historically it has been recognised that discrepancies of between 5% and 10% are not unreasonable in relation to actual flexibility capacity utilisation.

Flexibility requirements are predominantly demand driven and small variations in actual temperature within day, compared to forecasts, can result in significant variations in demand. As such a DNO User's actual flexibility requirements are very difficult to predict ahead of the Gas Day. Because they are demand driven, they are also very difficult to control within the Gas Day, particularly at pressure controlled offtakes.

Systems have traditionally been planned and designed to take account of such inherent factors. SGN has repeatedly argued that it is unreasonable and inappropriate to introduce commercial arrangements which introduce significant penalties for something that Users will have limited or no ability to control. SGN believes a tolerance of 3% would still be extremely challenging for Users, but it would at least provide a more appropriate starting point compared to 1.5% proposed by National Grid NTS under Modification Proposal 0116V. SGN believes a 3% tolerance would be more equitable, striking a more reasonable balance of risk between NTS and Users. The alternative would be for Users to overbook flexibility requirements to cover the risk of inaccuracies and avoid overruns. However we believe this would be a completely inefficient. We note that Modification Proposal 0116VB also recognises this issue and proposes a tolerance of 3%. In this respect, we support Modification Proposal 0116VB.

Negative Flexibility

Modification Proposal 0116V does not take full account of negative flexibility capacity and the potential benefit this provides to the system. Modification Proposal 0116VD explicitly recognises the benefit of negative flexibility capacity and makes sure it is taken into account when calculating flexibility capacity utilisation. We believe such arrangements are much fairer and more efficient. We believe Modification Proposal 0116V to be inefficient in this respect.

Pressure Commitment

Modification Proposal 0116V separates the process for submitting capacity requests and securing commitment for pressure requests. Capacity requests have to be submitted in July for Prevailing NTS Exit (Flat) Capacity and August for Annual NTS Exit (Flat) Capacity. Requests for Prevailing NTS Exit (Flat) Capacity have to be confirmed by NTS in September and requests for Annual NTS Exit (Flat) Capacity are confirmed within 48 hours. In comparison DNO Users can only request permanent changes in pressure in July, but a request doesn't need to be confirmed by NTS until 30 September. As such, there is a risk that a DNO User could submit a request for additional capacity and the corresponding pressure but later find the capacity is secure but the pressure is not. The DNO User would then be liable for capacity which would be useless without the corresponding pressure. We believe efficiency of arrangements could be improved by allowing arrangements to recognise the inter-relationship between capacity and pressure. SGN has proposed under Modification Proposal 0116VD a mechanism for DNOs to secure the necessary pressure in April each year, ahead of submitting their capacity request. This would avoid capacity being tied up

unnecessarily where DNO Users are unable to access the required pressure. We do not believe timescales would create any operating or planning difficulties for National Grid NTS.

Timescale for Notifying Transfer of Flex Between Exit zones

Under Modification Proposal 0116V and 0116VB Users are required to notify transfers of NTS Exit (Flexibility) Capacity to NTS by 12:00 for the following Gas Day. SGN believes this is unnecessarily restrictive and introduces inefficiencies as DNO Users will not have access to up to date information at this point in time to be able to accurately assess requirements for the following Gas Day. SGN believes the efficiency of the arrangements could be significantly improved to ensure the most efficient use of capacity by allowing requests to be submitted up to 14:00. We do not believe this would adversely affect NTS's ability to operate the network for the following Gas Day.

Liability for Failure to Make Gas Available for Offtake

Under Modification Proposal 0116V National Grid NTS has proposed that where there is an aggregate Exit (Flat) Capacity overrun at an NTS Exit Point or aggregate NTS Exit (Flexibility) Capacity overrun at an NTS Exit Zone and as a result NTS fails to make gas available for offtake at another NTS Exit Point or Zone, any User which incurs an overrun charge should also be liable for failure to make gas available costs incurred by National Grid NTS. SGN believes this is inappropriate. Overrun charges have already been set at an extremely high level to provide a strong incentive for Users not to overrun. To then expose Users to NTS liability payments introduces double jeopardy. We believe NTS should remain fully exposed to liability payments. We believe they provide an important incentive to ensure NTS takes all reasonable steps to manage the situation and find alternative ways to make gas available for offtake. Modification Proposal 0116VD removes the requirement for Users to compensate NTS. We believe this provides for a more efficient outcome.

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SGN believes Modification Proposals 0116V, 0116VB and 0116VD promote the above relevant objective in so far as they meet the obligation set out in Standard special condition A55, requiring Transporters to use their best endeavours to implement enduring offtake arrangements in a form approved by the Authority. They also help ensure the transportation business of NTS is conducted in a manner to avoid unfair and unduly discriminatory arrangements. This does not mean that SGN believes that DNO Users and Shipper Users must be treated in exactly the same way. SGN believes there are important differences between DNO Users and Shipper Users in terms of:

- the way in which they utilise NTS Exit (Flat) and (Flexibility) Capacity – DNO User requirements are essentially driven by demand on the DN. As such DNO Users have very little control over short term flexibility capacity requirements, particularly at pressure controlled offtakes.
- it is essential that DNO Users have access to information regarding NTS capability and costs and are able to enter into arrangements that provide a firm commitment from NTS. DNO Users need to be able to plan to meet requirements on their system under various scenarios. Cost information must allow DNO Users to determine the most efficient means of meeting demand. In contrast Shipper Users have repeatedly indicated that they will find it difficult to accurately predict future capacity requirements and provide commitment over several years, given current contractual arrangements and the nature of the change of supply process.
- A DNO Users ability to compete in a commercial market will be restricted by price control and incentive arrangements. DNO Users will not have the commercial discretion that Shipper Users might have.

We believe that it is important that arrangements take account of such fundamental differences and do not introduce unnecessary risk for any category of User or disadvantage one category relative to another. We believe this is possible without applying the same arrangements. SGN has some sympathy with the view expressed by some Shipper Users and is concerned that there could be an adverse impact on the efficiency of the proposed arrangements. However, SGN believes that proposals to remove flexibility capacity arrangements under Modification Proposal 0116VA and 0116VC could introduce additional complexities and risk as proposals are not clear how any future requirement for additional flexibility capacity for Shipper Users would be accommodated to ensure any additional capacity is allocated on a fair and equitable basis relative to other Shipper Users and DNO Users, as stated above. Therefore, in the absence of robust proposals to deal with this issue, we support Modification Proposal 0116VD rather than 0116VA or 0116VC.

(d) so far as is consistent with sub-paragraph (a) and (c) the securing of effective competition

We are concerned that all of the proposed modifications raise issues about complexity and will do nothing to better facilitate competition. We believe that simpler alternatives were available to address the issues raised by the DN sales, but we note that Ofgem has determined that such alternatives should not be considered further in favour of exit reform.

Against this background, while Proposals 0116V, 0116VB and 0116VD are intended to secure effective competition between existing Users, we believe the additional complexity introduced under arrangements could act as a barrier to entry. As stated above, customer representatives and Shipper Users have repeatedly expressed concern regarding ability to provide long term indications of requirement and financial commitment. Given the relatively short duration of most contracts with customers and the nature of the change of supply process, the proposals are likely to increase complexity and introduce additional risk for Shipper Users. This could create a barrier to entry with incoming Shippers potentially finding it increasingly difficult to access capacity to meet customers' requirements, particularly in the constrained period.

However, these issues have already been considered in Ofgem's decision to pursue enduring exit reform and, of the alternatives available we consider that modification 116VD provides the least impact on competition.

Implications for security of supply, operation of the Total System and industry fragmentation.

SGN believes all proposals have potential consequences for security of supply as they remove Interruptible Supply Points and only allow for limited release of interruptible capacity on a daily basis. As such it is possible that under a Network Gas Supply Emergency firm load shedding could be reached earlier if no consequential action is taken. On the other hand, if NTS receive appropriate signals and invest in the network, there may be no or limited overall impact. We would expect such issues to be a key consideration in HSE's assessment of Safety Case changes.

Implications for operation of the system have been covered above.

We do not believe there are any particular implications for industry fragmentation.

Development and Capital Cost and Operating Cost Implications

SGN believes there are likely to be significant costs implications associated with implementation of all of the above Modification Proposals, except 0116VA. SGN is currently updating its impact assessment and will be responding to Ofgem's cost information request. SGN believes that any decision on whether to recommend and implement proposals for reform must take full account of all potential costs and benefits.

Extent to which it is appropriate to recover the costs.

To the extent that the costs associated with implementing NTS offtake reform are efficiently incurred, SGN believes it is reasonable that DNO Users should be allowed to recover such costs. It would not be appropriate to expect DNO Users to fund reform of NTS arrangements. SGN believes it is important that cost recovery is considered as part of current Price Control discussions with Ofgem.

Changes will be required to DNOs Gas Distribution Transportation Charging Methodology Statement to take account of new charges to be levied on DNO Users by NTS. SGN anticipates that such costs will be fully recoverable from DN Shipper Users. However discussions are ongoing with Ofgem as part of the Distribution Price Control Review and discussions are also ongoing regarding incentive arrangements. Until NTS charging arrangements have not finalised, it is not possible to reach any conclusions in this respect. However SGN believes that there are now significant timing issues as DNO Users would have to consult on charging arrangements early in the new year to ensure arrangements are finalised in sufficient time.

The consequences of implementing the Modification Proposal on the level of contractual risk of each Transporter

SGN believes all of the above proposals increase the level of risk to DNO Users. For example, the requirement to provide 4 years financial commitment in order to secure additional Prevailing NTS Exit (Flat) Capacity, the introduction of pay as bid auctions, the level of overrun charges and introduction of credit arrangements for DNO Users, significantly increase the financial risk for DNO Users. The lack of detail regarding NTS's liability in relation to failure to deliver capacity and separation of pressure and capacity booking arrangements all introduce additional operational risk for DNO Users. SGN believes that

some of the incremental changes proposed under 0116VD help mitigate some of the risk compared to 0116V, particularly in relation to pressure commitments and flexibility capacity tolerance levels. 0116VD provides for a more equitable sharing of risk between NTS and DNOs.

High level indication of the areas of the UK Link and other systems likely to be affected together with development implications

NTS has indicated that it intends using the current IS infrastructure and Gemini system to facilitate the registration of NTS Exit Capacity (except through the OPN process). Similar functionality to that currently used to manage entry arrangements is expected to be made available to Users. We understand implications are still being assessed by NTS. We would expect full details to be made available as part of the Ofgem cost information request. SGN will comment more fully once details are known.

In addition SGN anticipates that some internal development costs will be incurred in developing our own systems. Details are still being updated and will be submitted in our response to the Ofgem cost information request.

We believe it is essential that all costs and benefits are fully considered (not just implementation costs) in determining whether the proposal better facilitates the relevant objectives. As arrangements are significantly more complex than the existing regime, it is likely that costs will be significant. It is essential that benefits are tangible and substantially outweigh potential costs.

As stated above, SGN believes that Modification Proposal 0116VD will better facilitate the relevant objectives, relative to other Modification Proposals. Modification Proposal 0116VD has the greatest potential to provide for the economic and efficient operation of the pipe-line system and secure effective competition. SGN believes there will be additional complexity and risk associated with all proposals, relative to the status quo. There is also likely to be significant additional cost to the industry. However on balance, 0116VD is preferable relative to the status quo. Perhaps additional benefit could have been gained by referring all proposals to Workstream for further development as there are aspects of each which are attractive. However, as things stand, we are required to consider each proposal on its own merits. As such SGN supports Modification Proposal 0116VD

We hope you find these comments helpful.

Yours sincerely

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