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Conclusions on Operating Margins Contestability and Initial Thoughts for Associated SO Incentive Arrangements September 2008

Dear Ian

In our response to the Initial Proposals consultation¹ we agreed that it was appropriate for National Grid Gas (NGG) to consider the provision of Operating Margins (OM) gas by other non-storage based service providers given their licence obligation to promote competition in the provision of the OM Service.

The current document contains a comprehensive description of the existing provision of OM services, identifies potential service providers and outlines the processes, procurement options and contractual relationships that would need to be put in place. It also sets out the associated UNC and Safety Case changes that would need to be made. In our view, the requirement to make a material amendment to the Safety Case represents a significant barrier to introducing competitive service provision which outweighs the changes to the commercial framework that might be required. This will affect the provision of OM services by all of the providers identified by NGG.

We agree that CCGTs are theoretically well placed to provide OM services, but it must be accepted that CCGTs will need to reflect the forgone electricity revenues or costs of switching to alternative fuels when pricing the service, particularly if offering the OM Service at long lead times. To mitigate this, our preference would be to offer the OM service at close to real time through the OCM, although we recognise that this option is not supported by NGG. An alternative approach might be to contract ahead of time to deliver a flow rate change. NGG could aggregate a group of CCGTs (or industrial loads) to increase the likelihood of delivery. This would retain the potential for diversity of providers and locations.

¹ Operating Margins Contestability – Initial Consultation, April 2008

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The work to develop contestability interacts with development of the wider gas System Operator (SO) incentives and NGG has argued that the SO incentive design should be able to deal with the complexity and uncertainty that increased contestability might bring and be flexible enough to cope with the evolution of the market for OM. We agree that SO incentives could be used to stimulate the market, which suggests that reform of the current OM incentive might be phased in until enduring arrangements are put in place. However, with the uncertainty over if and when competition might emerge given the significant legislative and commercial hurdles that need to be overcome, it is not clear that the incentive should be changed at this time. For the 2009/10 SO Incentive period NGG should carry on procuring OM services in the manner they have done historically, subject to incentive arrangements.

Our response to the specific questions raised in the consultation are set out below.

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

Yours sincerely

By Email So Unsigned

Charles Ruffell
Economic Regulation

SPECIFIC CONSULTATION QUESTIONS

Q4.2.1: Do you believe National Grid Gas has correctly identified the physical and contractual processes for OM Service provision from LNG Importation?

Yes

Q4.2.3: Is there anything you feel that National Grid Gas has overlooked, which may impact the ability of LNG Importation terminals with storage to provide an OM Service?

No

Q4.2.4: (For LNG Importation terminal operators/users): Would you be interested in providing the service? What more do you think National Grid Gas could do to encourage participation in OM Service Provision from LNG Importation terminal operators/users?

No. LNG Import terminal flows are driven by the movement and relative price differences in regional gas markets. OM service provision would place obligations on a LNG import terminal, particularly one without storage, that would be too operationally restrictive and which would destroy too much economic value to warrant participation in any tender exercise.

Q5.1.1: Do you believe National Grid Gas has correctly identified the physical and contractual processes for OM Service provision from NTS Connected Loads?

CCGT operation is largely driven by the spark spread which varies from day to day. CCGT shippers are unlikely to be able to guarantee in advance to provide a set volume of electricity load reduction as they are constantly assessing the spread and adjusting their trading position accordingly. Any generator committing to provide an OM service would significantly reduce the optionality of their CCGT plant and any back up generation plant. Whilst in theory it might be possible to place a value on this optionality, in reality the uncertainty surrounding the extent and timing of the OM requirement and the lack of liquidity in the short term electricity wholesale markets make it difficult to imagine CCGTs could offer this service at a price which is competitive with other sources.

Q5.1.2: Who would be most appropriate to aggregate provision from a group of CCGTs or industrial loads (e.g. Shippers, an Agent, or National Grid Gas)?

Shippers may have a number of CCGTs or industrial loads within their portfolio which in theory they might be able to spread offers of OM provision across. They may also have a portfolio of other generating plant which could in theory be used to offset the electricity loss resulting from OM provision by a CCGT. Shippers have also on occasion acted as market aggregators for smaller standalone generators in provision of demand side services in electricity and gas.

However, due to the inherent operational and contractual difficulties associated with OM provision by CCGTs we doubt any shippers will step forward to actively offer such services. In reality therefore NGG may be the only option for sourcing OM provision from a variety of demand side sources in quantities which in aggregate exceed the required amount.

Q5.1.3: Is there anything you feel that National Grid Gas has overlooked, which may impact the ability of NTS Connected Loads to provide an OM Service?

In the event OM provision by CCGTs loads is required within 2 hours NGG will need to consider the impact this might have on the electricity balancing market as the CCGTs operating parameters may be such that an orderly load reduction can only be achieved by instigating this post gate closure.

Also, the prospect of a generator buying cover for the load lost from OM provision at such short notice is remote bearing in mind the current level of liquidity in the electricity wholesale market.

Q5.1.4: (for NTS Connected Loads): Would you be interested in providing the service? What more do you think National Grid Gas could do to encourage participation in OM Service Provision from NTS Connected Loads?

No. We believe that the inherent contractual and operational difficulties associated with OM provision by CCGTs will effectively prevent OM provision by CCGTs in an economic and efficient manner.

Q5.2.1: Do you believe National Grid Gas has correctly identified the physical and contractual processes for OM Service provision from Supply/Interconnection?

Yes

Q5.2.2: What effect do you believe the long term reservation of headroom of supply would have on the market?

Long term reservation of a headroom of supply (and to a lesser extent capacity) could sterilise gas which otherwise could be made available to market. This would create market inefficiency which would put upward pressure on wholesale market prices.

Q5.2.3: Do you agree with National Grid Gas's view that current European legislation leaves importation facilities unable to offer an OM Service?

We do not agree that current EU legislation prevents interconnectors offering an OM service but we do accept that the current RTPA exemptions and long capacity bookings make it unlikely any interconnector would wish to at present.

Q5.2.4: Is there anything you feel that National Grid Gas has overlooked, which may impact the ability of Offshore Supply to provide an OM Service?

No

Q5.2.5: (For Offshore Supply operators/users): Do you see OM Service provision as viable? Do you think National Grid Gas should encourage participation in OM Service Provision from offshore supply operators/users?

No. It is difficult to see what measures NGG could take that would encourage participation in OM service provision from offshore supply operators/users bearing in mind the obvious contractual and operational barriers that exist.

Q5.3.1: Do you believe National Grid Gas has correctly identified the physical and contractual processes for OM Service provision from DNs?

Whilst not a DN, NGG's summary appears to be accurate.

Q5.3.2: What do you consider to be the most appropriate form of OM Service provision from DNs (e.g. demand reduction or demand deferral)? Is there scope for both to be provided?

We do not believe that either form of OM service provision is efficient or particularly appropriate under the circumstances, although it is theoretically conceivable that a DN might be able to offer an OM service by retaining diurnal storage facilities on its network which it otherwise might have decommissioned.

Q5.3.3: Do you think that it would be right for National Grid Gas to contact directly with shippers of DN loads, or should the DN be the contracting party?

We think DNs should be the contracting party for any OM service provision relating to flow increases on their networks and the Gas Act Exemption Order should provide for this. This principle is consistent with the principle adopted under enduring exit reform.

Q5.3.4: Is there anything you feel that National Grid Gas has overlooked, which may impact the ability of DNs to provide an OM Service?

We are not aware of anything

Q5.3.5: (For DNs): Would you be interested in providing the service? What more do you think National Grid Gas could do to encourage participation in OM Service Provision from DNs?

N/A

Q5.1: To what extent do you believe that National Grid Gas has fully considered the extent to which Storage, NTS Connected Loads, LNG Importation, Supply/Interconnection and DNs could provide the OM Service?

We believe NGG has fully considered this and has accurately represented the difficulties associated with these classes of User providing an OM service.

Q5.2: To what extent do you believe that National Grid Gas has sought to address barriers to provision of the OM Service from Storage, NTS Connected Loads, LNG Importation, Supply/Interconnection and DNs? Are there other barriers to service provision which National Grid Gas may or may not be able to remove?

We do not believe it is possible for NGG to effectively remove the inherent barriers to OM service provision by these classes of User.

Q5.3: Who should be allocated the gas when OM is utilised? Should the shipper have an option that it can be reallocated the gas against its balancing and gas-in-store portfolio?

Whilst it might be logical to allocate the gas to the shipper, if the shipper reduced its inputs to avoid being long on the day this would be counterproductive. Alternatively it would be possible for NG to purchase the gas by way of a Physical Market or Locational Market transaction priced either at a price detailed in the OM service contract or at SAP/SMP Buy prevailing on the day the OM service is required.

Q5.4: Would you be interested in providing the service? What more do you think National Grid Gas could do to encourage participation in OM Service Provision?

No. In our opinion OM service provision can currently only realistically be provided by gas in store and no amount of encouragement by NGG is likely to change this in the short to medium term.

Q6.1: To what extent do you believe the use of Minimum and Maximum Offtake Rates facilitate a usable measure of available provision?

Minimum and maximum offtake rates would be one method of facilitating available provision but will restrict the option value associated with running the CCGT optimally against the spark spread.

Q6.2: What are your views on the best way to determine the volume of gas associated with the utilisation of OM from demand and supply side sources? Should OPNs and Delivery Flow Notifications (as defined in Network Entry Agreements) be used?

It is hard to see how NGG could determine the extent to which OM from demand and supply side sources could be utilised without recourse to the OPN or DFN. To the extent any demand side or supply side source does wish to tender for OM service provision the terms and conditions of the contract should specify how the OPN/DFN should be provided (presumably electronically) and the consequence of any inaccuracy. However, any increased rigour in these arrangements deemed applicable for the provision of an OM service should not be applied carte blanche to other NTS Exit an Entry Points not providing such services.

Q6.3: What do you believe to be a suitable penalty arrangement for failure to make the OM Service available?

Bearing in mind the considerable barriers to OM provision by shippers and DNs it would be entirely inappropriate to penalise them for non participation in any future OM service tender, or to make veiled threats to introduce licence modifications mandating them to do so.

Q6.4: What do you believe to be a suitable penalty arrangement for failure to deliver the OM Service?

We agree that those classes of user who are able to provide an OM service and who contract to do so should face financial penalties linked to the duration and magnitude of any failure, priced as a multiple to SMP Buy. It would be inappropriate to artificially weaken any financial penalties in an attempt to encourage greater competition due to the serious consequences to the integrity of the NTS that may arise from failure.

Whilst NGG's failure to comply with the Safety Case is a criminal offence which cannot be assigned, transporters shippers, storage operators and inter-connector operators have a statutory duty under the Gas Safety Management Regulations to co-operate with NGG to enable them to comply with their Safety Case. In the event such a party contracted for OM provision (as required under NGG's Safety Case) but then failed to deliver against their obligations for reasons other than force majeure it is conceivable that this could be considered a criminal offence.

Q7.1: Do you agree with National Grid Gas's view that short-term procurement is unsuitable of the OM Service?

We understand the difficulties associated with short term procurement of OM services and why the HSE may require NG to demonstrate procurement of OM services have been secured in advance. Nevertheless we believe short-term procurement is the only realistic way of securing greater OM participation by shippers, DNs and inter-connector operators.

Further consideration could perhaps be given to allowing shippers to contract for a service whereby they commit to posting locational OCM offers during specified times or at specified notice period, which could be called upon by NG to provide an OM service as and when required. However, it would be difficult for shippers to specify in advance what the price of any OCM offer and therefore would be difficult for NGG to gauge the extent to OM service provision by this route would be more cost effective than procuring it in advance.

Q7.2: Do you agree that the proposed OM zones are a sensible way of determining the extent to which alternative locational OM providers exist?

Whilst OM zones are a way of splitting GB up for the purposes of OM procurement, this is only appropriate to the extent that the locational OM providers that are theoretically able to provide this service choose to do so.

It is also not clear to us the significance of these zones and how they may with the overlap/interact with the NTS Exit Zones and Linepack Areas, which may be introduced under enduring NTS exit reform.

Q7.3: To what extent do you believe the ability to tender for a variety of contract commencement dates and durations will benefit potential providers?

Whilst this may assist storage providers and LNG importation facilities with storage, in the absence of short term OCM procurement this will make little difference to other potential providers.

Q7.4: In addition to the proposal to publish minimum and maximum OM requirements on both a locational and non-locational basis, what other information do you feel would be useful for a potential OM provider considering participation in an OM procurement exercise?

We are not aware of any other information that may assist potential OM providers.

Q7.5: What approach do you think National Grid Gas should take to OM procurement if few or no additional OM Service providers result from the efforts made to develop further contestability?

NGG should carry on procuring OM services in the manner they have done historically, subject to incentive arrangements and caps on the provision of OM from its own quasi monopoly facilities.

Q8.1: Should National Grid Gas continue to be incentivised to assess and procure overall OM requirements on behalf of the industry?

Yes

Q8.2: What should the objective of the OM incentive be and what is the most appropriate parameter against which to measure performance?

The objective should continue to be for NGG to minimise the overall cost of holding and utilising OM gas.

Q8.3: How might incentive targets and structures be set to promote long-term cost management strategies, recognising the trade-off between the accuracy of the incentive target and the potential economic benefits of longer-term procurement?

We see no obvious benefits at this stage of moving away from annually set incentives. However, an average unit cost target and annually reset volume targets may be a workable solution for any longer term incentive.

Q8.4: How should the incentive develop to drive innovation and potentially promote the aims of the OM contestability work?

NGG should be encouraged to take more physical/locational OCM trades through its residual balancing incentive. This will stimulate shippers to place more physical/locational offers and give NGG more confidence that physical/locational offers will be available to meet the requirements for OM services going forward.

Q8.5: Should the incentive treat the procurement of the Orderly Rundown requirement differently from other OM requirements, given its storage-based nature?

We believe OM provision will be largely storage-based for some considerable time to come and therefore do not think such a distinction is necessary.

Q8.6: Should the incentive be designed to share risks and rewards between National Grid and Shippers (i.e. through sharing factors, caps and collars), should this be linked to the development of contestability and is there a contestability 'trigger' point where such arrangements should be introduced?

To the extent that NGG can continue to procure significant amounts of their OM requirements from third party storage it may be appropriate for the current incentives to appropriately reflect this through the introduction of sharing factors and caps and collars. To the extent that further contestability develops from facilities other than storage facilities this should be reviewed again, but we do not think it appropriate to define a trigger point at this stage.

Q8.7: Is the difference between the Storage Year and financial year significant enough to warrant changing the incentive start date potentially introducing accounting and reporting complexity into the arrangements?

Bearing in mind we believe that OM provision will be largely storage-based for some considerable time to come we do not think such a change is warranted.

Q9.1: Do you have any processes or timescales that might interact with a winter OM procurement exercise that you would like to make National Grid Gas aware of, so that they can be taken into account when designing the detail of the procurement exercise?

No