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By Email

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Dear Ian,

RE: Conclusions on Operating Margin Contestability and Initial Thoughts for Associated SO Incentive Arrangements

Thank you for the opportunity to comment upon National Grid's initial thinking in respect of contestability in the provision of operating margins. This response is submitted on behalf of the Centrica group of companies excluding Centrica Storage Limited.

We remain of the view that scope exists not only for OM provision other than stored gas, but also for a wide range of innovative procurement approaches. We believe that cost efficiencies can be realised as a result. In particular we are keen that this process tackles the current procurement practice, whereby National Grid effectively receives the highest of a fixed regulated price paid for capacity and market price, and this process appears to include scope for this anomaly to be rectified.

Our initial response also highlighted that we believed that, given the similarities between safety monitors and OM gas, there should be an examination of the possibilities of combining these two requirements into a singe category of stored gas and/or demand reduction. We are somewhat disappointed that this does not appear to have been considered in any detail.

We set out below our thinking in respect of each of the questions posed by the consultation:

4.2.1 and 4.2.3. We believe that National Grid have accurately captured the position with respect to the role of LNG importation in providing OM gas services, and believe they can continue to play an important, and potentially increasing role, in OM provision..

4.2.4. Whilst we are not able to commit at this stage, as a capacity holder in the Isle of Grain phase 2 and phase three expansions we will carefully assess the merits of any future OM regime.

5.1.1. We agree that National Grid has accurately assessed and captured the main physical and contractual issues and processes for NTS connected load OM provision. We would, however, highlight a general concern that National Grid appears to be leaning towards a CCGT demand reduction procurement option which requires the CCGT to contract some significant way ahead for interruption. Whilst the consultation document provides National Grid's reasoning behind this approach, we are concerned that such an approach could severely limit the take up of this option by CCGTs. Rather, we believe that an appropriate price and offtake rate reduction for interruption can only be arrived at much closer to real time, pointing much more towards an OCM type approach.

The potential availability of NTS interruption could be impacted following the likely introduction of NTS exit reform; depending upon the Authority's decision on how to proceed with exit reform there may be less incentive for NTS connected loads to maintain interruption capability. If there is some real value to be derived from using NTS interruption for OM purposes then this needs to addressed as part of any future development of interruptible services.

5.1.2. Where a shipper was responsible for a number of CCGTs (or other NTS connected loads), it seems evident that that shipper is in a good position to act as an aggregator for demand reduction to satisfy locational reduction requirements. However, it could be that a better response could be achieved by having a single, central agent acting in this role, who would be able to act on behalf of a larger portfolio of loads.

5.13. As stated above, we believe that the approach outlined may push contracting periods too far into the future to be particularly attractive, especially for CCGTs. In such circumstances, CCGTs may require a significant price premium to cover their potential exposure to electricity prices.

5.1.4. As a major player in gas fired generation, we would consider taking part in OM provision, depending upon the particular business rules agreed for provision of that service. However, looking at the limited take up rate by both customers and DNs in response to the recent round of DN interruption tenders, despite the best efforts of shippers to promote this opportunity to customers, we are concerned that significant effort may be required to garner interest from other customers.

5.2.1. We agree that National Grid has correctly identified the physical and contractual position with regard to OM provision by upstream supply and interconnectors.

5.2.2. to 5.2.5. Whilst we agree that upstream and interconnector OM provision poses challenges, we believe that OM provision by these sources is worthy of greater consideration. We would welcome the opportunity to discuss this in more detail with National Grid and other industry participants, including non-UK players, in order to see if these potential obstacles can be more accurately quantified and indeed overcome.

The potential for procuring excess gas from offshore supply sources should be viewed as not only a possible source of operating margins gas but, if it can be secured, as a means of reducing the operating margins requirement.

5.3.1 to 5.3.4. Whilst we have no direct DN ownership or operation interests, we would tend to believe that where a market was structured to achieve the best price for OM provision from any source for any given OM event, there is no reason to believe that DNs themselves (via their assets/infrastructure), or DN connected loads should not wish to take part in the process. We believe that demand deferral and demand destruction can both potentially play a part. As above, we would be keen to work with National Grid and the industry to understand and discuss potential barriers in more detail and see if these can be reasonably overcome.

5.1. and 5.2. Whilst we broadly consider that National Grid has undertaken reasonable analysis of the issues facing alternative OM provision, there remain a number of areas, for example upstream gas supply and DN gas/interruption provision, where further discussion is warranted. This review of OM provision seems a particularly good opportunity to establish whether lower OM costs can be achieved utilising a wide variety of means and it would seem a shame to conclude the process without the degree of debate that this deserves. We would therefore encourage a workshop type approach to present the findings of this exercise to date, and to highlight the barriers to further OM provision identified thus far.

5.3. We believe that the shipper should have the option to be re-allocated the gas in order to assist its balancing position. This approach may help to lower the risks for the shipper of taking part in the process, and therefore the price that the shipper may require.

5.4. We are keen to assess every opportunity open to us as a shipper to engage in a competitive OM market, and are also keen to ensure that competitive OM provision is open to as many other participants as possible. Hence our comments above about working to understand and overcome barriers to OM provision.

6.1. We believe it would be difficult for CCGTs to contract significantly ahead of real time for a maximum offtake rate, although we recognise National Grid's requirement for some certainty over OM availability from this source. Minimum offtake rates may be a more workable solution.

6.2. We would tend to agree that the use of the OPN in order to determine OM provision is appropriate.

6.3. and 6.4. We are somewhat concerned at how any proposed penalty arrangement for failure to interrupt could work out, given the CCGTs uncertainty over its generating profile much into the future. We would prefer to see a market based approach where those able to offer the service at the time of the OM event, at the best price, was selected. The use of any kind of penalty regime may simply serve to deter participation.

7.1. We believe that an option and exercise regime could be made to work. If correctly structured, the option price would reflect the provider's fixed costs of interruption, and this could be contracted far enough ahead as to give National Grid the comfort t needs with regard to availability. The exercise price would accurately reflect the market conditions at the time of the OM event. This regime would also more readily lend itself to a penalty arrangement.

7.2. The use of zones on the NTS has to some extent been proven through, for example, the capacity Trade and Transfer process, where it reflects usage of common elements of the NTS. It would therefore seem to us that the use of zones could logically extent to locational OM provision as well.

7.3. We fully support the use of flexible commencement dates and durations, and indeed delivery rates. The availability of such flexibility is much more likely to attract greater participation, as well as the best possible prices. It is these innovative procurement strategies that we believe will ultimately drive efficiencies into the OM process.

7.4. Potential new OM service providers will need to be able to review detailed business rules to have certainty in the process they are signing up to. We believe that we are still some way from that stage.

7.5. We agree that the current position with respect to DN interruption tenders does not tend to bode well for the success of a competitive alternative OM market. However, we believe that opening up the possibility of OM provision to as many parties as possible will provide the greatest chance of success. For these reasons, as outlined above, we would support greater industry debate on this subject to overcome barriers wherever possible. If it transpires that National Grid has no option but to continue to use constrained LNG type services and other reliable storage, as is currently the case, we believe more stringent regulation is the only option, and would be particularly keen to see the unwinding of the current "higher of" regime with regard to capacity.

SO Incentives

8.1. We agree that National Grid Gas should continue to be incentivised to assess and procure overall OM requirements on behalf of the industry.

8.2. The overall objective of the OM incentive should be to minimise the cost to shippers subject to meeting the valid requirements for provision of OM services. This should firstly be about minimising the OM requirement. Secondly there is a possible interaction between (a) estimating the OM requirement and (b) procuring OM services. We need to know more about how OM requirements are calculated and what assumptions about the availability of interruption and excess gas are built into the calculations (for example if some assumed interruption became an OM service would this simply leave things in the same net position?). The most appropriate parameters against which to measure performance are any justification for the volume provided and the cost at which that volume was procured.

8.3. We believe that competitive procurement should be used as far as possible and if appropriate this could include longer duration provision.

8.4. The form of incentive with 100% sharing factors is no longer appropriate and should only apply to regulated LNG costs where the floored market-related price requires the use of 100% sharing factors. Where OM services are provided on a competitive basis lower sharing factors which recognise this form of service provision should be introduced from April 2009. The incentive should drive this move towards the provision of OM services on a competitive basis.

8.5. See the answer to 8.4. If the procurement of Orderly Rundown can be from a combination of regulated LNG services and other (unregulated) storage services then sharing factors should be set as appropriate to the extent that unregulated services provide space for this purpose.

8.6. We agree that an incentive which is designed to share risks and rewards, should be linked to the development of contestability and that such incentives should be introduced as soon as there is any element of contestability in the provision of OM.

8.7. The difference between the Storage Year and financial year should not warrant changing the incentive start date. Any booking for April can be taken account of when setting the incentive for a particular year.

Centrica does agree that all appropriate physical locations should be able to compete for this on equal terms.

Please do not hesitate to contact me if you need any clarifications or details relating to this response.

Yours sincerely,

Chris Wright
Commercial Manager