

**National Grid Company's interest in Lattice
Energy Services**

A consultation paper

July 2003

Summary

The National Grid Company (NGC) is the licensed electricity transmission system owner and operator in England and Wales. As a consequence of the merger between National Grid Group plc and Lattice Group plc to create National Grid Transco plc (NGT) in late 2002, NGC became affiliated with companies that had interests in the generation of electricity. Ofgem issued consents under condition C2 and special condition AA3 of NGC's transmission licence, without which the affiliation would have placed NGC in breach of its transmission licence. In the case of Lattice Energy Services' interests in three combined heat and power (CHP) stations, the consents were time-limited (subject to possible extension) and will expire in October 2003.

Since completion of the merger, NGT's subsidiary has disposed of its interests in two of the three CHP stations for which time-limited consents were issued. Disposal of the interest in the third station has been prevented (in NGT's view) by technical issues that were not foreseen at the time of the merger (and the issuing of the original consents). NGC has requested that Ofgem extend its consents relating to the third CHP station to permit an orderly sale to take place (ie, a sale with more than one potential purchaser, therefore capable of achieving a market-based price).

This consultation paper seeks responses from interested parties on Ofgem's initial view that an extension of one year to October 2004 should be granted.

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1. Summary Impact Assessment

Issue

- 1.1. The National Grid Company (NGC) is the licensed owner and operator of the electricity transmission system in England and Wales. Ofgem considers that full vertical separation between the operator of an electricity transmission system and customers of that system (ie, generators and suppliers) is important for market participants to be confident that access to the system will be fair, transparent, and non-discriminatory. NGC's transmission licence gives effect to this principle, for example by preventing NGC and its affiliates from having an interest in the generation or other acquisition of electricity.¹ The relevant licence conditions are reproduced in appendix 1.
- 1.2. Prior to the merger between National Grid Group plc and Lattice Group plc to create National Grid Transco plc (NGT), Lattice had interests in a number of electricity generating stations. Transco's gas transportation licence does not contain restrictions on activities relating to the generation or other acquisition of electricity.
- 1.3. At the time of the merger that created NGT, Ofgem took the view that retention of the generating interests within the combined group would be acceptable, in the short term, because the stations were small, connected to the local distribution network rather than the high-voltage transmission system, and were environmentally beneficial in nature. Ofgem therefore issued the necessary consents under condition C2 and special condition AA3 of NGC's transmission licence. In the case of the three combined heat and power (CHP) stations belonging to NGT's subsidiary Lattice Energy Services (LES), the consents were time-limited (subject to possible extension) and will expire in October 2003.²
- 1.4. Ofgem's intention, in issuing time-limited consents, was to permit NGT to effect an orderly disposal of its interest in the CHP stations (ie, a sale with more than

¹ except for certain defined purposes relating to the efficient and economic balancing of the system

² see *Regulatory issues arising from the merger of National Grid Group plc and Lattice Group plc to create National Grid Transco plc—Decision document and notices under sections 11 and 11A of the Electricity Act*

1989 and section 23 of the Gas Act 1986, Ofgem September 2002

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one potential purchaser, therefore capable of achieving a market-based price). LES has disposed of its interests in two of the three stations. However, technical issues (discussed below), which were not foreseen at the time that Ofgem issued the consents, have so far (in NGT's view) prevented orderly sale of the third plant, a 22.4 MW station in Cleveland. NGT believes that these technical issues could be overcome by October 2004. NGC has therefore requested that Ofgem extend the relevant consents by 12 months to this date.

- 1.5. The Cleveland CHP plant operates as a 'tolling project', with LES paid a fee for converting gas (bought by the CHP customer) into electricity and steam. The plant is scheduled by the customer, and the LES fees are not linked to gas or electricity prices.
- 1.6. Since the CHP plant in question is small and connected to the local distribution network rather than to the high-voltage transmission system, Ofgem considers that any possible detriment associated with NGC's affiliation with LES is likely to be very small. Nevertheless, Ofgem continues to believe that the principle of separation between the operator of an electricity transmission system and its customers is important to the proper functioning of an effective and competitive wholesale market.
- 1.7. Ofgem and the DTI are currently developing new British Electricity Trading and Transmission Arrangements (BETTA), targeted for implementation in April 2005. In a June 2003 consultation paper, Ofgem and DTI stated that, if NGC is appointed as the GB system operator under BETTA, Ofgem/DTI would not intend to replicate existing consents, issued to NGC at the time of the merger resulting in the creation of NGT, to take account of generation and supply interests held by Lattice Group plc, beyond the BETTA implementation date.³

Objective

³ see *Regulatory framework for transmission licensees under BETTA—second consultation on electricity transmission licences under BETTA*, Ofgem/DTI (June 2003), chapter 11
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- 1.8. In deciding whether to approve NGC's request for extended consents, Ofgem is seeking to achieve a balance between an important regulatory principle—separation between an electricity transmission system operator and its customers—and delivering regulatory solutions which are reasonable in the circumstances.

Options

- 1.9. The options available to Ofgem are to refuse NGC's request, issue consents to run to October 2004, or issue consents to run to a different date.
- 1.10. At the time of the merger that created NGT, Ofgem decided that permitting an orderly sale of the relevant generating interests was a reasonable solution to the regulatory issue that was to arise as a result of the merger creating NGT. In particular, Ofgem considered that the detriments associated with the generation interests remaining within the NGT group were relatively small (but significant), and that forcing an instant sale would not be proportionate.
- 1.11. Were Ofgem to refuse NGC's request, it is not likely (in NGT's view) that an orderly sale will now be possible. The value of the transaction to NGT shareholders could therefore be reduced if no extension were granted.⁴
- 1.12. To grant an extension would extend the (relatively small) detriment associated with the CHP plant remaining within the NGT group. Furthermore, Ofgem is aware that market participants may hold certain expectations on the basis of the time-limited consents issued at the time of the merger. Ofgem would highlight that, given the prevailing circumstances, it did at the time reserve the right to extend the consents.⁵
- 1.13. Ofgem considers that the original consents created an expectation that NGT would seek to dispose, in an orderly fashion, of LES interests in the three CHP

⁴ Ofgem understands that the total value of the CHP project is of the order of £10m

⁵ *op. cit.* (p.71)

plants for which time-limited consents were granted. LES has subsequently disposed of its interests in two of the three plants.

- 1.14. In requesting an extension to the consents for the third plant, NGT explained that, after the issuing of the original consents, technical constraints arose that may have a material impact on the value of the CHP plant and associated utility tolling agreement. Ofgem understands that the technical constraints include issues relating to emissions of nitrogen oxides (NO_x) from the plant—there has been uncertainty over whether the Environment Agency will require abatement equipment to be fitted to the plant, which has created significant uncertainty about the value of the plant and the associated utility tolling agreement.⁶ As a result, in NGT's view, LES has been unable to dispose of its interest in the plant in an orderly fashion within the timescale originally envisaged to be feasible. NGT has told Ofgem that, were Ofgem to extend the consent by 12 months to October 2004, it would be possible to resolve this uncertainty and thereby achieve an orderly sale.

⁶ Ofgem understands that the most recent emissions data, from May 2003, indicate that the plant is operating within current permit conditions and relevant Environment Agency technical guidance. The issue is expected to be resolved in January 2004.

2. Timetable

2.1. Interested parties are invited to comment on this document by no later than August 12th 2003. After considering responses, Ofgem would expect to publish its decision before the end of August.

2.2. Responses should be sent to:

Toby Brown
Head of Strategy and Corporate Transactions
Ofgem
9 Millbank
London SW1P 3GE

or by email to toby.brown@ofgem.gov.uk

3. Conclusions

3.1. At the time of the merger that created NGT, Ofgem issued time-limited consents to allow the three CHP plants in which LES had an interest to remain within the NGT group, taking the view that retention of the generating interests within the combined group would be acceptable, in the short term, because the stations were small, connected to the local distribution network rather than the high-voltage transmission system, and were environmentally beneficial in nature.

3.2. On the basis of NGT's view that the technical issue that has prevented an orderly sale can be resolved to permit an orderly sale by October 2004, Ofgem's initial view is that extending the consents to this date would be reasonable. In reaching this initial view, Ofgem has taken into account the following factors:

- ◆ that the CHP plant is relatively small and connected to the local distribution system (and hence the detriment associated with the retention of the interest in the plant within the NGT group for a further 12 months is relatively small);
- ◆ that LES has disposed of its interests in two of the three CHP stations for which time-limited consents were issued;
- ◆ that, in NGT's view, uncertainties arose after the original consents were issued that prevented an orderly sale;
- ◆ that NGT's view is that the extension would allow uncertainties associated with technical issues that have arisen since issuing the original consents to be resolved, and thereby to permit an orderly sale; and that
- ◆ Ofgem indicated at the time of issuing the consents that they could be extended.

3.3. Ofgem welcomes responses from interested parties on this initial view. Ofgem would be particularly interested in views from respondents as to the significance of any possible detriment (eg, to the operation of the wholesale market) associated with NGT's interest in the CHP plant continuing for a further 12 months.

- 3.4. If Ofgem were to extend the consents to October 2004, it would not expect further extensions to consents permitting NGT's continued ownership of LES to be necessary (unless material changes in circumstance occur which could not reasonably now have been foreseen). In any event, Ofgem (and the DTI) have stated that if NGC is appointed as the GB system operator under BETTA, Ofgem/DTI would not intend to replicate existing consents, issued to NGC at the time of the merger resulting in the creation of NGT to take account of generation and supply interests held by Lattice Group plc, beyond the BETTA implementation date.

Appendix 1

NGC's Electricity transmission licence

Condition C2—prohibited activities

1. The purpose of this condition is to prevent abuse by the licensee of its position as owner and operator of the licensee's transmission system.
2. The licensee shall not and shall procure that any affiliate or related undertaking of the licensee shall not, on its own account (or that of the licensee or of any affiliate or related undertaking of the licensee as the case may be), purchase or otherwise acquire electricity for the purpose of sale or other disposition to third parties except with the consent of the Authority.
3. In paragraph 2, the reference to the purchase or other acquisition of electricity shall include entering into or acquiring the benefit of a contract conferring rights or obligations (including rights or obligations by way of option) in relation to or by reference to the sale, purchase or delivery of electricity at any time or the price at which electricity is sold or purchased at any time.

Special condition AA3—supplementary prohibited activities

1. Except with the written consent of the Authority the licensee shall not and shall procure that any affiliate or related undertaking of the licensee shall not, on its own account (or that of the licensee or of any affiliate or related undertaking of the licensee as the case may be), purchase or otherwise acquire electricity for the purpose of sale or other disposition to third parties except pursuant to the procurement or use of balancing services in connection with operating the licensee's transmission system and doing so economically and efficiently.
2. Paragraph 1 shall not apply in respect of the purchase of electricity under a supply agreement dated 9th February 1983 (as from time to time amended) and vested in the licensee pursuant to the transfer scheme, for the acquisition and sale of electricity from Kielder hydro-electric generating station.