

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

Decision document

August 2003

Summary

In July 2003, following a request from the National Grid Company (NGC), Ofgem issued a consultation on whether NGC should be permitted to retain an interest in Lattice Energy Services (LES, the operator of a 22MW combined heat and power plant at Cleveland Potash) beyond October 2003. NGC requested the extension on the grounds that, in its view, technical uncertainties had prevented an orderly disposal of its interest in the plant. Ofgem's initial view was that an extension of twelve months to October 2004 would be a proportionate regulatory response in all the circumstances, taking into account the important principle of separation between the operator of a transmission network and its customers.

Following consultation with interested parties, Ofgem has decided to extend the necessary consents to permit NGC to retain its interest in LES for an additional six months, to April 15th 2004. In so doing, it is Ofgem's expectation that NGC will use its best endeavours to ensure that a sale is effected by the revised deadline. Were the sale not to be completed by the time that the relevant consents expire, NGC would be in breach of its transmission licence.

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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. NGC's transmission licence prevents NGC and its affiliates from having an interest in the generation or other acquisition of electricity.¹ 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.
- 1.2. 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 generation interests 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
- 1.3. Ofgem's intention, in issuing time-limited consents, was to permit NGT to effect an orderly disposal of its interest in the CHP stations.
- 1.4. In July 2003, following a request from NGC, Ofgem issued a consultation³ on whether NGC should be permitted to retain its interest in LES beyond October 2003. NGC requested the extension on the grounds that, in its view, technical uncertainties had arisen after the original consents were granted that had prevented an orderly disposal of its interest in the plant.
- 1.5. Ofgem's initial view was that an extension of twelve months to October 2004 would be a proportionate regulatory response in all the circumstances, taking

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

into account the important principle of separation between the operator of a transmission network and its customers (ie, generators and suppliers). Ofgem's July consultation paper explains the reasoning behind this initial view in more detail.

Objective

- 1.6. 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 (ie, generators and suppliers)—and delivering regulatory solutions which are reasonable in the circumstances.

Options

- 1.7. 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.

Ofgem's initial view

- 1.8. 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 was that extending the consents by one year to this date would be reasonable. In reaching this initial view, Ofgem took 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.

Consultation responses

- 1.9. Ofgem received six responses to its consultation, including one from CPL (the customer of the CHP plant) and one from CPL's parent company.
- 1.10. Four respondents felt that, on the basis set out in the consultation paper, Ofgem's initial view was a proportionate response to NGC's request. One of these respondents (Scottish and Southern Energy, which presently owns and operates part of the high-voltage transmission system in Scotland, as well as having significant interests in generation and supply) disagreed with Ofgem's view on vertical separation between transmission network operators and their customers, maintaining that such separation can effectively be achieved within the same group structure.
- 1.11. CPL expressed the view that there had not been any material change in circumstances since Ofgem issued the original consents, and that to extend the consents would therefore be inconsistent and add to regulatory uncertainty. CPL also took the view that potentially interested purchasers had rejected the opportunity to purchase the plant because of the need to make additional capital expenditure to ensure that the plant would run to its contractual requirements. CPL also stated that the availability of emissions data for the plant now meant that there was no significant uncertainty associated with NO_x emissions.
- 1.12. CPL went on to state that the availability of the CHP plant has been below the contractual specification, and to express the view that significant changes are required to improve the availability of the plant. CPL is of the view that improvement is not likely given the current uncertainty until the sale has been completed, and therefore that an extension to the consents will prolong the period of poor performance. CPL said that it is willing to buy out LES's interest in the plant at a 'realistic' price.

2. Conclusions

Ofgem's decision

- 2.1. Ofgem continues to attach importance to the principle of vertical separation between a transmission network operator and its customers, and also recognises the benefits to the industry as a whole of maintaining regulatory consistency and certainty. Ofgem does not consider that it should examine or intervene in purely commercial contractual matters between CPL and LES.
- 2.2. A key issue, in NGC's view, that has been preventing an orderly sale has been technical uncertainty associated with NO_x emissions. Ofgem notes that the recent availability of historic emissions data is likely to reduce this uncertainty and to allow prospective purchasers to form a more certain view of the value of the plant. Ofgem also notes CPL's view that nothing has changed since the time that Ofgem issued the original consents.
- 2.3. Ofgem recognises that a protracted sale process may be detrimental to the interests of CPL as customer of the CHP plant, although Ofgem also notes that CPL has a commercial contractual relationship with LES in respect of the CHP project.
- 2.4. Nevertheless, Ofgem maintains its initial view, supported by several large market participants that responded to the consultation paper, that NGT should have the opportunity to conduct an orderly sale of its interest in LES.
- 2.5. Ofgem considers that extending the period of its original consent by six months to April 15th 2004 provides NGT with the opportunity to effect an orderly sale. Ofgem's view is that information on the operation of the plant, including emissions levels, which is now available would tend to reduce the uncertainty that NGT argued had arisen since Ofgem's initial consents were granted at the time of the merger creating NGT, and that NGT argued had prevented an orderly sale.
- 2.6. In reaching this conclusion, which it considers to be reasonable in the circumstances, Ofgem has taken into account the responses to the July consultation paper, including the points listed above.

- 2.7. Ofgem expects that NGC will use its best endeavours to ensure that a sale is effected by the revised deadline. Were the sale not to be completed by the time that the relevant consents expire, NGC would be in breach of its transmission licence.
- 2.8. The relevant revised consents are published alongside this decision document.