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26 September 2003

Dear Kyran

**National Grid Transco: Potential sale of network distribution businesses**

EDF Energy welcomes the opportunity to comment on Ofgem's consultation on the potential sale of one or more of NGT's distribution networks (DNs). We believe that this project represents the biggest milestone in the UK gas industry since the Network Code was introduced in 1996, and as such warrants careful consideration to ensure that the right outcome is achieved in order to protect consumers and preserve the success of the current regime to date.

As a matter of principle, EDF Energy accepts that NGT should be permitted to make such disposals, if that is what it wishes, provided that the public interest and that of all other parties is protected. In particular:

- Given that the Regulatory Impact Assessment (RIA) will form the basis for Ofgem's final decision, it is essential that it is robust, taking into account all the costs that industry participants will incur and excluding benefits arising from other initiatives that are being pursued regardless of this proposal. Therefore, it may be worthwhile to have a "minded to" conclusion based on a provisional RIA in November on which the industry could be consulted, rather than a "go/no go" final decision. Ofgem could then present a timetable for appropriately considering the issues more deeply before committing itself and the industry to a lengthy, and potentially costly, piece of work.
- NGT should undertake to pay all costs arising from the proposal, including a reduction in transportation charges to compensate gas shippers for their reasonable costs in participating in the process and adapting their systems. We doubt whether the RIA comes close to demonstrating a public benefit that would justify the cost lying elsewhere.

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- The need to set up effective, reliable, and transparent arrangements, and to fully involve the shipper community in their development, must not be compromised to meet NGT's target timetable. While the work should proceed with all reasonable dispatch, undue haste will not be cost effective and could lead to mistakes. We share Ofgem's view that September 2004 is a highly optimistic date and think that a timetable should be formulated from the bottom up once the work plan is better defined.
- There should, of course, be a level playing field between retained and sold networks, and no discrimination in the way that gas market participants and customers are treated as between these entities.
- The normal compliance package should also apply, and be strictly enforced, where any network is sold to a group with supply or shipper interests. In particular, care must be taken to ensure that any supplier or shipper that might become the owner of such assets cannot operate them in such a way as to gain competitive advantage.

The attachment to this letter sets out our more detailed views on the issues raised. Among these points, we would highlight the importance of retaining a one-stop approach to supply point administration, which is essential to efficient customer service. We would also stress the need for the retained networks to be legally separated from NGT, whether or not it becomes necessary to introduce a separate gas distribution licence.

Finally, we would like to retain the current integrated governance arrangements in gas: many good initiatives in electricity are delayed by debates about the appropriate governance forum in which to take these forward.

We look forward to participating in the further development of this initiative. In particular, we believe it is imperative that all gas market participants are fully involved in taking forward any changes that are necessary to the gas trading arrangements in order to facilitate a DN sale.

Yours sincerely

A handwritten signature in black ink, appearing to read 'D. Linford', written in a cursive style.

**Denis Linford**  
**Head of Regulation**

## Attachment

### Regulatory architecture

EDF Energy believes that the level of separation between existing gas distribution networks (DNs) and future independent distribution networks (IDNs) merits careful consideration to minimise discrimination and ensure that a level playing field exists between Transco and its retained distribution networks (RDNs) and those IDNs which NGT chooses to dispose of.

In terms of licensing arrangements, we believe that the issues raised by separate ownership of the DNs could be addressed through either of the two options which Ofgem and NGT have identified. However, we consider that a single licence addressing the obligations for two distinct businesses could be complex to implement and apply. We also feel that the level of work needed to amend the gas transportation licence to cover both gas transmission and gas distribution networks could be as great as that needed to produce two separate licences.

The separate licence approach under option one would provide separate roles and obligations for transmission or distribution licence holders which would be clearly distinguished and identified. We agree with NGT that this would create a clear arm's length relationship between the transmission and distribution roles and functions which would be appropriate if the DNs were required to be separate legal entities.

In terms of the second option, we feel that it would be possible to continue with a single GT licence covering both transmission and distribution, while also distinguishing between the two by segmenting certain obligations pertaining to each network operator and switching some conditions on or off. However, we believe that this might prove to be an unnecessarily complicated way of dealing with the separation of roles and obligations and could hinder the development of both licensed businesses.

We recognise that while it seems more likely that the RIA would be positive if a single licence structure is relied upon, the downside is that in this context there might be more room for discrimination to develop between RDNs and IDNs. Appropriate incentives on both RDNs and IDNs would need to be structured so that they were encouraged to innovate and not to favour themselves at the expense of shippers and customers.

We also agree that there may be some scope for extending some of the licence obligations for DNs to Independent Gas Transporters (IGTs), as the latter would be, in effect, smaller versions of the DNs. We shall be interested to see whether Ofgem proposes to extend accession to the IGTs, and over what timescales.

### *Network codes*

We consider that a single Uniform Network Code would be more robust and that this could effectively deal with both operations and rules for a TO and a DNO by

segmenting the two areas. In other words, some parts of the code would relate to both TOs and DNOs, whereas other parts would apply independently depending on whether the participant was a TO or DNO. In this respect, we welcome NGT's intention to preserve the key features of the current commercial regime, causing minimal disruption to shippers and current legislation.

To assist in creating a non-discriminatory and competitive framework, we believe that there must be a clear separation between each of the RDNs and IDNs. This is a prerequisite for a level playing field between DNs, and for a transparent and competitive arena in which they can achieve the economies which Ofgem frequently refers to in its document. However, we are unsure about the best combination of licences and codes to achieve this, in view of the lack of detail and also the different permutations that each solution provides. For example, if one believes that there should be a single SO to manage and operate the security and balancing of the whole system, then a single unified code might be most appropriate, supported by a single licence.

On the other hand, if one believes that there should be multiple SOs balancing their own DNs, then this would necessitate DN codes and perhaps separate distribution licences as in electricity. Indeed, this scenario might even require individual codes, tailor-made for each DN, to take into account the distinct differences between the various DNs. For example, the Scottish DN would have to operate quite differently from other DNs because the lack of Linepack provision north of the border makes it intrinsically different.

It is for these reasons that we believe that the industry should tackle the development of different ownership of DNs from a bottom-up perspective to ensure that the right model is achieved. This should also assist future sales of more DNs and any further industry reforms thereafter.

### *Process issues*

The bottom-up approach outlined above should also apply to process. There is no point in establishing what the regulatory framework should look like at the top, and then discovering that it does not match the detailed structure at ground level. In particular, we must avoid the danger of forcing the industry to go down a particular route when deciding what type of exit or balancing regimes it wants. Optimal structural development at ground level may be prejudiced if the regulatory regime is designed top-down.

We therefore believe that sufficient work needs to be undertaken in the various workstreams before we can comfortably or accurately say which regulatory structure is better than another. In this respect, it would be useful if Ofgem and NGT could present some formal terms of reference for this project which would describe the principal objectives and goals for the sale in addition to the envisaged expansion of shareholder value. This description could perhaps be provided in the form of a mission statement from NGT which would be issued alongside Ofgem's detailed RIA before the publication of a final conclusions document.

## *Gateway concept*

The gateway concept is particularly important here, as it will form the foundation of any development of the sale. We believe that it would be inappropriate for Ofgem to consent to any disposal unless NGT has first agreed to each of the gateways being developed and has demonstrated that it would be able to meet all its objectives or milestones thereafter.

## **Regulatory Impact Assessment**

We welcome Ofgem's first RIA analysis for this consultation. We hope that it will contribute usefully to a final assessment of the merits of giving consent to NGT to proceed with a disposal. However, we recognise that the success of any RIA depends on the identification of good and reliable data, and we therefore feel that more detail is required in this area. For example, the range of values given in the scenario was not very wide or substantiated by an accompanying description of the values and their origin.

We find it difficult to assess the validity of the figures behind the low (£150m) and high (£330m) range scenarios in Appendix 5. However, we consider that they are probably a poor representation of the likely outturn costs and benefits, particularly if only one DN were to be sold. Even if Ofgem's current figures – which assume the sale of more than one DN – are robust, the net benefit to the end user, calculated on the basis of a 22m UK customer base, would be in the order of only £4 a year for the low range and £10 for the high range scenario. In view of the cost to the industry and NGT of achieving such savings, the disposal project as a whole seems unlikely to be economically viable, and it would therefore be surprising if NGT were to be allowed to go ahead with a sale without the prior comfort of a much more positive RIA.

While we are not in principle opposed to the disposal of a DN, we believe that the RIA will not become substantially positive unless it presupposes minimal change to the regulatory architecture. That, however, would increase the potential for discrimination between RDNs and IDNs. Therefore, the optimum regulatory structure in any RIA model needs to be weighed against the most efficient DN regime going forward.

We note that Ofgem's initial RIA may already contain some double counting. For example, potential cost/benefits from the reform of the Exit regime should not be included as part of the assessment, as these are currently ongoing and would provide costs/benefits regardless of whether the sale of a DN goes ahead or not. We set out below the matters which we believe should not form part of any RIA as they have already occurred and been taken into account regardless of the sale:

- Transco/NGC merger
- NGT grouping of the 12 LDZs into eight regional networks
- SPAA/customer transfer programme
- Separation of Transco's distribution price control
- Exit regime reform.

We note that Ofgem might consent to a disposal even if the RIA result is slightly negative. While we understand the reasons for this, we consider that some indication of the level of RIA negativity that would lead Ofgem to withhold its consent would be helpful.

We also believe that NGT's costs associated with the sale should be paid for by NGT itself, and should not be factored into any RIA. These are not costs which would be incurred by NGT in response to an external regulatory requirement. They would be the costs to NGT of implementing its own commercial objectives and should not be included in the RIA baseline. Excluding them will minimise the financial impact on the industry as a whole, since they should be reflected in the price that a potential buyer is willing to pay for the distribution asset.

We welcome Ofgem's request for more information from interested parties about the associated implementation costs for industry participants. As one of the five major suppliers and shippers in the industry, we believe that our implementation costs will depend largely on what type of regulatory regime is implemented. With that caveat, however, we have estimated that our operational, commercial, and technological costs of implementation could be within a base figure of £1m for the simplest and most practical regulatory regime, and between £3m and £5m for a more complex regime and associated structures.

### **Supply Point Administration**

The impact of a DN sale on the SPA part of the Network Code and on Transco's SPA operations and procedures is of particular importance to EDF Energy as one of the UK's largest gas suppliers. In the event of Ofgem consenting to a DN sale, we would wish to see minimal disruption to the way that we contract and communicate with Transco in the area of customer supply transfers and SPA systems and data flows. We therefore believe that there should continue to be a one-stop SPA process to minimise the cost to the industry of having to deal with separate DNs for the provision of SPA services.

We recognise Transco's intention to retain the provision of data services and the integrity of data across all DN networks. We believe that Transco's aim in this is to minimise industry change and complexities, so as to also minimise extra costs for industry participants and consumers. We welcome this approach and we believe that the current regime should only be changed if suppliers collectively wish to improve the current process, in which event this could be done under the SPAA and any reforms to the customer transfer process that may emerge from the current investigation across energy supply.

### *Agent issues*

In order to cause minimum disruption to current SPA arrangements, we consider that Transco should continue to own the current SPA business processes and systems, but that these should be operated by an agent outside Transco in a separate, ring-fenced legal entity within the wider NGT group. However, we agree that Transco needs to be incentivised to introduce more

flexible and innovative CoS/SPA arrangements, and this is an area where Ofgem could add considerable value in determining the optimum SPA regime in order to allow such benefits to be delivered. We do not believe that dealing with different DNs for the provision of SPA data services would be efficient and cost effective. There should be a one-stop shop for the provision of SPA services rather the agency functions being owned by both Transco and the DNs.

Our preference is for a Uniform Network Code which would govern gas transportation in respect of both transmission and the distribution functions.

### **The Exit regime**

We do not believe that there is a clear cut case for developing new exit regime proposals alongside the planning and implementation of a disposal project. The exit regime can be developed, and indeed is currently being developed, independently of any potential LDZ sale, as Ofgem has rightly recognised.

### **Energy balancing**

In line with our view that any DN sale should seek to minimise disruption to the current arrangements, we do not believe that there should be multiple SOs or individual balancing accounts. This would complicate the current gas trading arrangements and undo much of the work which the industry has done since the commencement of the Network Code. It would also jeopardise the success of the National Balancing Point market, which is generally recognised as superior to other European gas industry arrangements.

We agree with Ofgem that having multiple SOs could cause market distortions and extra costs, with the operator of a DN seeking to maximise its returns at the cost of the rest of the gas balancing system and other industry participants. This could also have considerable permanent effects on future gas prices and hence on future customer prices as a result.

Assuming Ofgem's consent to a sale, we believe that the best route forward would be to continue with current arrangements involving a single commercial national balancing entity supported by a concise offtake agreement which would govern the way in which the TO and the DO would contract for flow rates and physical balancing.

### **Offtake agreement**

We believe that the offtake agreement would be the best way of covering the operational and commercial arrangements between the NTS and the DNs and that Transco would be in the best position to provide a framework for this. We also think that the offtake agreement should be a generic agreement applying to all DNs to ensure that Transco does not discriminate between the IDNs and RDNs. This would also ensure that all DNs compete on a level playing field for the provision of flows, balancing services, and linepack. However, we recognise that there may need to be some exceptions reflecting the significantly

different circumstances of some DN areas (the current lack of linepack provision in Scotland is an example).

### **Treatment of Independent Gas Transporters**

We believe that a disposal project would offer considerable scope for aligning governance and procedures for the IGTs with those of the DNs. For example, the Uniform Network Code that we have advocated above could be extended to apply to IGTs, which currently work under separate individual codes which are not consistent across the piece.

### **Health and safety issues**

While it may still be too early for the Health and Safety Executive to become formally involved, we welcome its intention to take an active role in assessing any sale. We welcome the intention that Transco will retain the responsibility for providing the national gas emergency number through its call centres.

### **Other areas of impact**

We note that Ofgem's current corporate plan makes no reference to this project. We would like to understand the resources and expenditure that Ofgem thinks will be necessary to support it. Ofgem should publish its views on these matters in its November 2003 conclusions document so that customers, shippers, and suppliers can fully understand the linkages between the project and Ofgem's other commitments and project aspirations. This would also help the industry to better understand the next RIA that Ofgem publishes, since we assume that the costs of Ofgem's own project inputs would be a material element in this.

**EDF Energy**  
**September 2003**