26 September 2003

Kyran Hanks
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Office of Gas and Electricity Markets
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Dear Kyran,

Response to the Ofgem consultation on the potential sale of network distribution businesses

Entergy-Koch Trading Ltd (EKTL) welcomes the opportunity to comment on this consultation. EKTL supports the gateway concept for examining the potential sales as we consider that this will provide an appropriate incentive on NGT to participate in finding solutions to larger policy issues such as gas balancing and exit reform. We believe that that the decision by National Grid Transco to consider the sale of some distributional assets raises a number of potential risks and rewards.

We would expect that the separation of LDZ assets would lead to better price discovery on many shared services between the NTS and LDZ and could also produce some pipe-on-pipe competition where LDZ owners may seek, for example, to offer more interconnection between regions (perhaps by-passing the NTS).

The ability of LDZ to compete for gas services will, in addition to better benchmarking of regulated activities, encourage more efficient pricing and better quality services. In addition, the efficient pricing of services such as in-pipe storage may promote the creation of more risk products and services for the benefit of consumers. Overall, the sales could encourage greater competition and efficiency in the GB gas transportation market.

However, there are potential risks for system users. Key amongst these is the risk of fragmentation in terms of governance, contracts and invoicing. We would be very concerned if the final arrangements led to a situation where it became more expensive or contractually more difficult to move gas from the beach to consumers. We consider that the resolution of the contractual boundary issues is very important for the GB market and also will aid the development of competition policy in Europe where similar issues exist when moving gas between different networks with different governance and ownership.

Further, we would note the general observation on the valuation of benefits that companies derive from acquiring assets. In most cases, acquiring companies over value the benefits (often by misjudging the realistic level of cost reductions and the cost of integration). With the purchase of regulated assets, we would expect that the valuations would reflect a new owner's view that it could make greater cost savings than Transco could achieve. Should these benefits fail to emerge, the acquiring company may find that it is less able to satisfy its shareholder demands and seek redress through lobbying for revenue adjustments. The effect on corporate balance sheets from mergers and acquisition activity is normally of little interest to consumers. However with regulated assets and a captured customer base, the efficient operation of the assets is directly linked to the costs of use, and customers have been known to pay the price for corporate failures on networked infrastructure. A failure to derive a more cost efficient well-run business compared with the existing owners could lead to increased customer costs.

Specific comments on the consultation

Governance

With respect to governance issues, EKTL is most concerned about maintaining arrangements that will provide relatively inexpensive and administrable outcomes. The volume of network code changes is testament to the operation of a developing and flexible market so this evolution must be aided by well functioning processes. Further, we consider that the governance in the power industry provide some useful lessons for the gas industry.

The implementation of NETA resulted in the creation of several code and operational documents, including the Balancing and Settlement Code, the Connection and Use of System Code and the Balancing Services Adjustment Methodology Statement. We consider that the fragmentation of the codes has created additional administrative hurdles, particularly with respect to cross code governance and the development of effective policy responses. Having to consider consequential changes to other codes impinges on the timeliness of implementing new measures.

For this reason, we support having one network code document to cover both the NTS and DN parts of the gas system. Having separate network codes for different DNs has few tangible benefits and is more likely to result in confusion, additional costs for users and an increase in barriers to competition – particularly for smaller players less able to manage a significant increase in industry documentation.

A single network code will allow development to continue on a uniform basis as well as allowing rapid changes where necessary. The assessment of modifications by industry and Ofgem can also be considered against an overall operating environment, rather than having to give consideration to potential changes in other codes. Further, a single code will prevent situations where inconsistencies could drive inappropriate outcomes or conflicting objectives for users or network operators.

Not having separate codes could reduce some to the competitive pressures between DNs, although we consider that this effect would be small. In the broader vision of industry competition it is far more important to have governance arrangements that encourage the participation of many system users, as competition between these businesses is the key driver of economic benefits for consumers.

To ensure the most efficient operation of a single code, we support having an 'independent' body to govern the process (in a manner similar to Elexon). This has the advantages of removing the risk of dominance by Transco, and allows all parties including Transco to voice independent views on proposals.

With respect to licencing we consider that it is important to develop a licencing regime that can be understood by industry and by regulators. We would prefer a single licence regime for gas transporters, possibly where some conditions are switched on or off for NTS and DN type activities. The advantages of having one licence are:

- lower risk of diversion between transmission operators licence regimes;
- the potential to increase pipe on pipe competition, where a DN may decide to take on NTS type services without having to obtain a separate licence; and
- more manageable industry documentation.

Exit and interruptions

The sale of DNs places a greater importance on sorting out the contractual arrangements surrounding exit and interruptions, particularly the role of demand side bidding. We agree with Ofgem's gateway approach with respect to the exit arrangements, as the incentive on NGT to develop innovative solutions would not be as strong after the sale of assets.

- We recognise some of the early consideration of exit arrangements, particularly with respect to the contractual paths. At this stage we have no particular preference, but recognise the trade off between simplicity and efficiency.

Balancing

The balancing area raises some of the more difficult operational issues with multiple owners of pipelines. We consider that robust and innovative solutions in this area are important for system users and could provide valuable lessons for approaches taken in other EU markets.

A single SO should make system management easier, but it may restrict some product innovation and competition between different DNs for some services. Multiple SO arrangements would need some tight design arrangements to ensure that shippers will not pay for operator errors and that shipping operations are still kept whole as much as possible.

With respect to NBP liquidity, there would be some risk to NBP as a physical trading hub, although this is quite low given that trading is currently based around a virtual NTS hub. For the liquidity in this market to reduce, there would have to be some trading points emerge in the different DNs, which at this stage appears unlikely.

The use and payment for diurnal storage in the LDZ and NTS introduces some interesting issues. We would like to understand if the NTS ever 'parks' gas in the LDZ as a way of managing NTS flows. Table 6.1 of the document identifies linepack usage, but there needs to be some testing of these numbers against the recent linepack assessment in modification proposal 0513. The other issue is whether linepack be a contestable service so that shippers could compete with Transco for its use (perhaps as a tolerance service)?

SPA processes

Our initial thoughts are a preference for an 'Elexon' style solution as this is more transparent in terms of operations and costs.

Transmission and Distribution price controls

Ofgem has already undertaken some consultations on DN price controls, but we think there will be a need to revisit some of the proposals to take into account the different commercial and operational activities that a separate DN will have.

As noted above, it is possible that DNs will seek to develop new services and activities, including pipe-on-pipe competition and linepack services. The earlier consultations focussed on creating an environment that encourages benchmarking and comparisons between different DNs. But this does not go far enough, as there will be a need to encourage new asset owners to innovate and invest as well as to sweat the existing assets.

Decisions on how the system operations will work may also require changes to the price controls because a charge may arise between the DNs and the NTS SO for services that will interact with existing NTS SO incentives. For example, under a single SO approach, the SO may use some operational flexibility in a DN in order to minimise balancing actions. Transco may benefit under its balancing incentive based on the 'efficient' use of DN assets. The DN owner may not receive any of this benefit, but may keep paying an SO management fee to Transco.

Regulatory Impact Assessment

The regulatory impact assessment as presented in the document probably needs some greater explanation.

- The assessment should be clear about what is going into the £5 million costs for Ofgem. For example, does this include increased on-going monitoring costs that would arise from having multiple transmission owners?
- Shipper/supplier costs are difficult to model as the IT costs may depend on the chosen solutions. The NETA experience may be worth examining from a systems point of view, but there is also a need to consider the additional costs arising from the governance and contractual measures inherent in multi-party to multi-party arrangements. These costs will be very sensitive to the success of the acquiring party in driving cost efficiencies. As noted above, mergers and acquisition history is littered with poor results and this could result in cost increases.
- With respect to the benefits provided to customers, more efficient industry structures are a positive, but there is some risk that additional complexity will limit the amount of competition from a supply perspective, and this is likely to limit innovative products. Questions were asked at the seminar about whether the benefits from the comparative price regulation were being double counted given that Transco already have a significant level of benchmarking. There needs to be a clear exposition of how the benefits will transmit to customers. What is the mechanism and timing for this transmission? How does the new owner keep some of the created value?

I can be contacted on 02073378448 if you require further explanation of the points raised in this response.

Yours sincerely,

Adam Cooper
Regulatory Affairs
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