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Mr Kyran Hanks
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By Email

Dear Kyran

**NATIONAL GRID TRANSCO – POTENTIAL SALE OF NETWORK
DISTRIBUTION BUSINESSES
77/03 July 2003**

Innogy welcome the opportunity to respond to this consultation.

The proposals to sell one or more Distribution Network (DN) businesses require fundamental changes to the structure of the competitive wholesale and retail markets and to monopoly gas distribution and transmission activities. Different organisational imperatives and management structures in the DN businesses should allow the introduction of comparators between the retained (RDN) and independent (IDN) Distribution Networks and this should lead to efficiency improvements. In principle, we support initiatives that improve efficiency and lead to reduced costs to end-users and the sale of one or more DN businesses has the potential to reduce gas distribution charges. However, we are concerned that some of the business models presented will lead to significant additional transaction and operational costs for shippers and suppliers that will offset or even outweigh any potential efficiency benefits.

The “go/no go” decision to further develop these proposals that is scheduled in November appears to be unrealistic at this stage given the complexity of the proposals. Clearly, Transco wish to push forward, but we believe that a timetable needs to be established that gives sufficient time for all the interactions to be identified and considered. Ofgem’s proposed “gateway” approach, that defines changes or agreement to changes that must be in place before final approval, has some benefits. However, we are concerned that this may remove incentives to complete outstanding changes once approval has been given. The definition of which gateways need to be implemented rather than agreed will be key. This is particularly true where the gateway affects shippers’ ability to manage the customer relationship and anything that will impact on supply market competition.

In view of Transco's vested interest, we would like to see development work groups established outside of the network code workstream process. As a minimum, Ofgem should chair the relevant meetings.

Regulatory Impact Assessment

To quantify the cost-benefit of a DN sale, Ofgem has developed a preliminary Regulatory Impact Assessment (RIA) that indicates a positive benefit. We accept that it is far from straightforward to quantify the costs and benefits of these major proposals but, as presented, the RIA is inadequate. While we acknowledge its preliminary status, the RIA is too general and there is no data to explain the assumptions or support the conclusions. For instance, there is no justification for the assumed 1.3% per annum efficiency savings. Given its criticality to the November decision it is worrying that the analysis is so poorly developed and we would support any proposals to consult separately on the RIA.

Ofgem is making any sale conditional on the resolution of a number of issues, which inevitably increases the scope and scale of reforms. The rationale for linking such wide ranging reforms is presumably that areas such as exit capacity and the treatment of linepack need to be resolved as part of any DN sale in any case. This does make it difficult to untangle the effects of each individual change and although it might make sense to undertake them all together we would like this demonstrated.

Much is made of the positive benefit associated with reforming SPA and the exit and interruptions regime. We would like any benefits to be quantified for each separate area, especially as reform of the exit and interruptions regime was already being developed and was subsequently included in this process. A number of these initiatives are essentially stand alone and should be progressed irrespective of the decision on the sale of a DN. We would like to understand how these developments will be taken forward.

In addition, there will be separate DN price controls in place from April 2004. Presumably, any efficiency savings associated with this have already been factored into the RIA. For clarification, we would like Ofgem to explain the relationship between the RAV allocated to each DN to facilitate separation of price controls and charge determination and the actual physical assets associated with each DN. If these do not align then this creates a potential for windfall gains for Transco and will require the purchaser to increase its charges. How this fits with 25 year smoothing of locational pricing effects within the DN price controls is also far from clear.

Regulatory Architecture

We have already highlighted concerns that increased complexity may increase shipper costs. There is a balance to be struck between simplicity and ensuring that any arrangements are robust and do not discriminate between RDNs and IDNs.

A key determinant of the regulatory architecture is the extent to which the DNs are required to develop independently. In our view, this comes down to a choice of whether the focus is on encouraging supply competition or competition between networks. Clearly network competition will require a degree of separation and

independence of licences and network codes. This independence will be beneficial for the development of DN comparators but may have an adverse impact on supply competition if the interfaces with the various codes are overly complex. The level of competition to supply sites connected on IGT networks illustrates the point that complexity may be a barrier. Standardised pricing methodologies, consistent charging structures and common system interfaces will encourage suppliers.

Our current position is that we favour a Uniform Network Code, coupled with separate Transmission and Distribution licences. The benefits of this approach are that it establishes clearly distinguished roles, is non-discriminatory and allows some separate development of distribution networks if required. However, to ease the transition to the new arrangements, shippers will initially be offered the same services on all networks with differentiated services developing if required.

Offtake Agreement

To ensure non-discrimination between RDNs and IDNs we agree that an Offtake Agreement is needed to replace the current informal, internal arrangements for managing the interface between the NTS and the DNs. The precise scope of the Offtake Agreement is in part dependent upon the final Regulatory Architecture. We believe that it should primarily define the operational arrangements at the NTS/DN interface and should be developed based upon the framework proposed by Transco. There is much more work required to define the level and structure of the charges between the NTS and DN System Operators and we would not like to see any operational efficiencies lost because of inappropriate charging mechanisms. An example here would be the management of diurnal swing which is largely opaque to shippers and a feature of the integrated network. If commercial terms are defined in the Offtake Agreement there will be implications for shippers in terms of costs that may flow through. The Offtake Agreement should be transparent and subject to a modification process that is similar to that used for pricing methodology changes.

Exit and Interruptions

The inclusion of DN-connected interruptible loads, along with NTS loads, within the scope of exit reform has addressed one of the fundamental flaws of the Universal Firm Registration proposals. The existing interruption arrangements should be reformed and we endorse the objectives set out by Ofgem. We agree that increasing customer choice, maintaining system security, cost reflective pricing, non-discrimination and removal of cross-subsidies are key principles. We are still concerned that changes to the regime do not create cost distortions that cannot be offset or mitigated.

We assume that the objective of Transco determined interruption relates to Transco not over contracting. There are differences between Transco's requirements for peak interruption and the duration of that interruption. These are not distinguished at present under the standard 45 day service. Different contracting structures would allow Transco to align its requirements with the level of interruption procured.

Although the principle of using the regime to derive investment signals is worthy, we have doubts whether this objective could be met given that current contracting periods

are not consistent with investment time scales. There would also be a need to re-define exit capacity rights and possibly to introduce direct customer contracts with Transco. We believe that the primary contracting party should remain the shipper and cannot see any strong arguments for Transco contracting directly with customers.

A mixture of administered and “market-based” pricing could be introduced for exit capacity and interruption, although we doubt that there are sufficient interested players even on the NTS to sustain the market. This is a function both of the number of potential sites and the fact that trading in exit capacity is not a core business activity. When considered with distortions arising from locational constraints, any price signals may not be reliable enough to underpin investment. A hybrid model with Transco, acting as NTS SO, developing a suite of contracts of varying quantity and duration would be an improvement, especially where payment was more closely linked to the level and frequency of service provided. A shipper to a DN-connected site should be able to contract with the DN System Operator where that SO values the interruption. This may create competing demand for the interruption product and lead to some signal of the value of locational interruption. Although we believe that each SO should manage its own network, the contracting arrangements between the SOs and the shipper can be reflected in the information flows and interruption triggering mechanisms between the SOs set out within the Offtake Agreement.

Gas Balancing

There should be a single SO for balancing purposes as this will produce the most efficient balancing actions. We do not support balancing across individual DNs in a multiple SO model as this would lead to fragmentation of the NBP and increased shipper costs.

Our understanding is that linepack is available as a locational rather than as an “NBP” type product. This will influence the type of linepack service that can be developed. The value of linepack will vary as the system becomes more constrained, in much the same way as the various other storage services have different values related to their usage. What is not clear is who owns the linepack and where the costs and revenues fall. Is it owned by the SO and used for short-term system management or the TO, providing an alternative to system investment? Resolution of these issues will help determine, for instance, how inter-network gas flows are treated. We believe that this area needs considerably more development.

Supply Point Administration

The issues surrounding Supply Point Administration (SPA) are critical to the decision of whether a DN sale should proceed due to the potential impact on supply market competition. Suppliers cannot be expected to accept a solution that fragments the registration processes still further and requires duplicate systems or manual processes. Instead, consideration of a DN Sale should be regarded as an opportunity to implement standard systems for registration across all networks, the change control and governance of which will allow more supplier input than is currently the case. The IGT networks could be included and the core SPA activities aligned. Current SPA functionality and processes are entangled in the main Transco systems and this

limits the changes and degree of flexibility that can be provided to meet evolving customer requirements.

One option could be for SPAA to be managed by an independent service provider, owned or contracted by suppliers, to manage the registration process and the associated industry data. This option would require significant additional industry consultation and development. The evaluation of a potential DN sale provides, in our view, a timely opportunity to implement such a far reaching change.

Incentive Schemes

A challenge in a world without an integrated network owner/operator is to ensure that incentives are correctly established and aligned between the NTS, RDNs and IDNs. There are economies of scale and scope as well as operational efficiencies that will be lost. One example is the management of constraints; another would be incentives to invest. The NTS SO schemes are due to be revised from April 2004. If the proposed timetable for sale of one or more DN businesses is met then consideration needs to be given to ensure the revised incentives are consistent with separate ownership.

Conclusions

Innogy are committed to helping develop these proposals but remain to be convinced about the level of benefit to customers. A number of options for structural reform have been set out, many of which will require fundamental changes to the current regime. We welcome Ofgem's RIA but believe that it needs further development and ought to reflect the optionality inherent in the proposals. The proposed changes are widely scoped and we believe that the efficiency benefits need to be disaggregated and, perhaps, just those changes deemed necessary for a DN sale progressed under the auspices of this project. We support continued and possibly independent development in the areas of supply point administration and exit capacity reform.

We hope that these views are constructive and would be happy to discuss the issues further.

Yours sincerely

Charles Ruffell
Economic Regulation