Ofgem Consultation on National Grid Transco – Potential Sale of Network Distribution Businesses 77/03

Response by Powergen

Overview

1 Powergen believes that the proposed sale of a number of gas distribution networks (DNs) by National Grid Transco ("Transco") will yield substantial efficiencies both though new management of the divested businesses and comparative competition between the newly independent businesses and Transco's retained distribution networks (RDNs). In our view, the key efficiency gains will arise mainly in the operation and maintenance of, and investment in, DN assets (for example, from cost savings arising from multi-utility operation), and not in differentiation between DNs in terms of codes, charging methodologies and billing systems. Unnecessary fragmentation and complexity in any new arrangements necessary to facilitate DN divestment could increase costs for shippers and suppliers of gas. Ofgem's presentation on its initial regulatory impact assessment (RIA) at the seminar on 10 September illustrated how the costs could outweigh the benefits if few DNs were sold and costs to shippers rose to £100M.

2 We believe that only those reforms that are necessary to facilitate the sale of gas distribution businesses, to enable them to be managed effectively by an independent owner, and to ensure that Transco does not discriminate in its treatment of its own DNs and those which are independently owned, should be required at this stage. Although changes to the gas exit/interruptions regime and supply point administration will be required in particular, wholesale reform of these areas (as suggested by Ofgem in chapter 10) should not be a pre-requisite for DN divestment. Making divestment conditional on such reforms would unduly delay or even prejudice the sale of DNs and the efficiency gains which could accrue from them.

3 We support limited reforms to the exit/interruptions regime and also consider the introduction of the supply point administration agreement (SPAA) to be important in giving suppliers greater control over critical customer service delivery processes. It is essential that these reforms are conducted in a way which delivers the right outcome for the market. They should not therefore be accelerated just to facilitate the DN divestment process. Each of these developments should be allowed to proceed at its own pace and work by Transco to facilitate possible gas DN divestment should be limited to what is "expedient and necessary" to achieve that objective. The aim should be to design the regulatory architecture and market rules in such a way that the change of ownership is, as far as possible, 'invisible' to shippers, suppliers and customers.

4 In our view the critical contractual relationships should remain with Transco, with a unified GB network code and common charging methodologies, and any Transco/DN offtake

agreement should simply enable Transco to continue to fulfil its existing obligations to shippers under the unified network code. Arrangements would need to be amended once the SPAA is introduced (but as we said earlier that should be viewed as a separate project). The above perspectives inform the following views on the more detailed issues which are addressed in the order in which they are set out in the consultation.

Regulatory Decision Making Framework

5 The framework of contractual relationships, codes and governance should be designed to provide adequate checks and balances, transparency and effective participation of industry stakeholders.

6 We believe that there should only be a read across from the electricity market to the gas market where there are good reasons to do so. In particular we do not see a case for transferring the complex code structure which exists in electricity to gas. The Transco Network Code, which contains technical and commercial arrangements in one code, is the cornerstone of the UK competitive gas market and should not be unpicked without good reason. We also do not see a need to amend the way in which transportation charges are levied. 'DUoS' charges in gas (or more correctly local distribution zone (LDZ) transportation charges) are levied for conveyance of gas from the NTS to the customer's meter. This is a service charged to shippers and is not strictly analogous to DUoS charges applied to supplies in electricity.

7 The benefits of national, consistent, standardised market rules for the transportation and trading of gas should not be underestimated. Equally the experience of fragmented structures in other industries could well be a key concern for the Health and Safety Commission. We would therefore urge Ofgem to minimise any necessary changes to the regulatory architecture. We have sought to suggest a number of ways in which this might be achieved below:

NGT's Proposals

8 Generally the scope of the sale of assets envisaged by Transco seems sensible. There seems to be a difference of understanding, however, between Ofgem and Transco as to what activities should be included within the agency role. Ofgem seems to believe it encompasses mainly SPA activities whilst Transco considers it to cover the full range of shipper service activities including SPA. It would be helpful if this apparent discrepancy were resolved.

9 The establishment of an agency to carry out certain shipper activities is not itself essential for a DN sale. What is required is appropriate internal separation of these particular activities within Transco so that such an agency can be established at a future date, if this is considered appropriate.

Regulatory Architecture

10 In this section we seek to describe those matters, which need to be resolved, before the sale should be allowed to proceed (the 'gateway concept').

Internal Separation

11 The principal objective should be to ensure that Transco does not discriminate in favour of its own RDNs at the interface between the NTS and DNs and that independent DN owners have the assurance that this is the case. We would favour similar arrangements to those which work successfully to separate out distribution from other energy activities within integrated energy groups.

Licensing arrangements

12 We prefer a licensing structure which provides for separate gas transportation and distribution licences. This would support business separation within Transco, help avoid discrimination by Transco between its own and independent DNs and provide greater clarity for the distribution licensee. The Collective Licence Modification process will need to ensure that the interests of a minority number of independent distribution licensees are protected. We do not believe that such a structure will create additional costs for suppliers and shippers.

Future Network Code Arrangements

13 The competitive market for shipping and supply of gas is built on a single uniform network code. In 1996 it replaced a diverse range of negotiated third party gas transportation agreements. It established standardised and non discriminatory terms for access to the then integrated British Gas pipeline network from the beach gas terminal to the customer's meter. Unnecessary fragmentation of this agreement is unlikely to enhance wholesale gas trading or competition in shipping and supply.

14 We therefore support retention of a uniform network code (Ofgem option 2) in which Transco's relationship with shippers[1] remains much as it is now. DNs will of course need to be able to participate in its development. Transco can ensure it can fulfil its obligations to shippers through the new offtake agreements with each DN. It is not necessary for each DN to establish individual network or 'distribution' codes. It is generally acknowledged that the requirement on each independent gas transporter to produce individual network codes has introduced unnecessary complexity for market participants and has adversely affected supply competition across those networks, and we would want to avoid replicating that across each DN.

[1] We acknowledge that it is appropriate to establish a separate SPAA agreement at a future date but such a change is not essential for the sale of network distribution businesses.

15 Even a uniform distribution code is unlikely to offer a satisfactory solution, given that it necessarily draws an arbitrary line between distribution and transmission activities. Separate codes, whether these are represented by Ofgem's option 1 or 3, will inevitably introduce unnecessary rigidities into the regulatory architecture, which may be unable to adapt to future developments in industry structure.

The NTS/DN Interface and Offtake Agreement

16 The offtake agreement will define the split in responsibilities between Transco and DNs in managing particular gas transportation activities. We see this as essentially a standard form bi-lateral contract through which Transco fulfils its obligations to shippers under the uniform network code. Its scope would therefore be fairly wide ranging and in our view should incorporate all the factors outlined in both paragraphs 4.45 and 4.49 of the consultation. The governance of the market rules would remain subject to the existing network code modification rules and it would be Transco's responsibility to ensure any consequential change to relevant offtake agreements are made. Under this contractual structure the offtake agreement would be subordinate to the uniform network code.

17 The offtake agreement envisaged is much wider in scope than the existing network exit agreements (NExAs). NExAs were primarily designed to give Transco greater control over the offtake of gas at very large daily metered customers (VLDMCs), and it is particularly important in defining ramp rates and flow rate notice periods. Given the difference in scope of these agreements, we don't see there is any real merit in seeking to apply the offtake agreement to NExAs. Such agreements are certainly not on the critical path for facilitating the sale of DNs.

Impact and options for exit and interruptions regime

18 Some reforms to the exit and interruptions regime are essential to facilitate the sale of DNs. It should not, however, be necessary for Transco to commit to wholesale reform in these areas for Ofgem to give its consent.

19 Whatever regime is eventually established we believe Transco should manage the arrangements centrally. We do not see that it is appropriate for DNOs to offer interruption flexibility to Transco and then in turn to have to establish their own interruption arrangements for shippers/end users (option 1). Interruption flexibility is effectively 'owned' by shippers and their customers and should by offered to the system operator that has responsibility for balancing the system as a whole (i.e. Transco). We therefore believe that the present method of determining interruption should be retained (Option 2). Option 3 (Transco contracting with end users) may seem attractive but we are sceptical that this would result in much more flexibility being offered into the market. Much of this flexibility can already be provided to Transco via the on the day commodity market (OCM).

20 An important long-term issue mentioned by Ofgem in the consultation paper is how to place appropriate incentives on each DN SO so that they can 'make efficient trade-offs

between investment in pipeline capacity and the use of interruption and LNG'. Essentially we see this as an additional service over and above any interruption rights vested in the overall system balancer (Transco), for managing transportation constraints, supply/demand matching and national emergency circumstances. Ultimately one could envisage that DN SOs could contract with shippers or end-users in their region for turn-down contracts as an alternative to investment in pipeline capacity. This would not be interruption for energy balancing purposes, but interruption to manage constraints in its pipeline network. If local turn-down contracts were agreed by a DN SO with end users, a process would have to be established to make the shipper aware of the reduced quantity of gas offtaken, so that that shipper could adjust their deliveries into the system.

21 Powergen is not in principle against a universal firm exit regime; however, such a radical change to the gas regime should not be made without addressing the adverse effects that will be faced by some end-users. The supply of back-up gas to power stations normally served by dedicated pipelines is a case in point. Connah's Quay in particular offtakes gas from the NTS on an interruptible basis and payment of an annual firm tariff (without any prospect of turn-down income from Transco) would be prohibitively expensive and damage its competitive position in the generation market. We therefore believe that a range of products, including a daily firm exit and within-day firm exit service, should be offered to address these crucial concerns.

Impact and Options for Gas Balancing

22 We believe that gas balancing across the system should remain centrally managed by the NTS operator. The multiple SO model would needlessly fragment the market, and require each shipper to balance both within the DN and within the NTS, increasing transaction costs and potentially threatening trading liquidity at the national balancing point (NBP).

23 The key gas balancing question raised by the potential sale of DNs is how to price fairly and manage linepack at the NTS/DN interface. Our preference would be to establish a methodology which would derive long run marginal cost signals for investment in NTS linepack across the system and use these signals to allocate the total cost of NTS linepack (including Transco regulated return) to LDZ exit points. We would envisage that charges would be levied mainly on a capacity basis (although the additional cost of varying pressures in the NTS compared to a system operated at constant flow rates may justify a small commodity element). A ratchet mechanism could be applied should a DN SO exceed its booked linepack at a given LDZ exit point. The NTS linepack charges would be set to recover that proportion of the NTS allowed revenue that is necessary to provide linepack services to LDZs. To derive the proportion of NTS costs that relate to the provision of LDZ linepack one would first have to establish the cost of network sized only to transport gas flowing at relatively constant flow rates and add in some limited flexibility to cope with within day flow variations at entry and NTS connected customers.

24 Once reasonably cost reflective charges for NTS linepack are established, each DN business, going forward, would have the option to invest in its pipeline network and associated assets (including gas holders and storage bullets) as an alternative to continuing to purchase NTS linepack.

25 Management of LDZ linepack is a matter for the NTS SO and the DN SO and is essentially about managing flow rates between different parts of the national gas transportation system. It does not require DN SOs to trade gas with shippers. The DN role should be to operate its pipeline network to ensure shipper's gas is in the right place at the right time so that they can continue to supply customers. Transco in its role as NTS SO would, however, continue to buy and sell limited amounts of gas for residual gas balancing purposes. Given that we would not foresee a need for DNs to take on a gas balancing role, the current Transco balancing incentives can continue much as they are now.

26 Operationally we would envisage that DN SOs would instruct Transco as to how much diurnal linepack flexibility they would wish to take from the NTS across the day. One might expect Transco to place limits on the amount of NTS linepack used and the respective stocks of gas actually 'loaned' from one system to the other on a day to day basis.

27 In our opinion the management of pressures (and by definition the use of linepack) in the NTS and DNs are operational issues for the respective SOs. Appropriate management of linepack is crucial to safe operation of the system and in maintaining security of supply. Handing over 'control' of linepack operations through the offering of linepack services to shippers is unlikely to improve matters. We therefore see little value in the suggestion that IDNs, RDNs and the NTS should have financial incentives to provide linepack services.

Impact on Supply Point Administration Process

28 We do not consider it necessary for Transco to reach agreement on the nature of the agency arrangements or their funding before Ofgem gives consent to the sale of a DN. Any agency carrying out activities on behalf of DNs should be owned jointly by participating DNs to ensure that they have a stake in and an incentive to improve systems and processes. Powergen supports changes to the supply point administration processes and is actively supporting the introduction of the SPAA. Many of the issues outlined in this consultation are part of the SPAA project and should be progressed separately.

Other Aspects of the NTS/DN interface

29 We believe it is best to keep shrinkage arrangements in the hands of Transco at this early stage, although incentives will need to be developed to encourage DNs to invest to reduce shrinkage on their own networks in a similar way to the incentives on DNOs to reduce losses in electricity. At the very least the purchasing of shrinkage gas should remain with the NTS SO, as other approaches could involve the DN SOs purchasing gas on open markets, which we would not support. Similarly incentives with respect to gas quality and

pressure should stay with Transco as the DN SO will not have any control (save for odorisation) over the quality of gas entering its system.

30 Coordination of planning and investment between the NTS and DNs will be a difficult issue to solve. A similar issue arises with respect to the relationship between the GB SO and TOs under the BETTA project. It is important that, if there is disagreement between the parties on particular planning and investment issues, one party must have the ultimate authority to make a final decision. Any party that is overruled by the other should not be financially worse off as a result. For example the DN business may be worse off under a particular regulatory incentive scheme as a result of Transco's investment decision, in which case Transco should hold that DN business harmless with respect to increased downside costs or reduced upside revenues under such a scheme.

Related Issues

31 It is difficult to say whether it is appropriate to revisit Transco NTS and LDZ price controls at this point in time. However any purchaser will need clarity about the price control regime and, if further changes are envisaged in the short term, what the scope of these could be.

32 Powergen wishes to avoid unnecessary complexity and fragmentation of transportation charging arrangements that may result from DN divestment. Whilst a common structure of charges should be maintained, the level of charges will clearly vary from DN to DN according to their cost to serve, and the DN must be allowed some flexibility in the relative level of different elements of the charge. This would allow the DN to vary the proportion of fixed and variable elements of the charge, without requiring shippers to build new systems to accommodate several different charging structures. In addition, there could be a modification process to allow smaller DNs to propose modifications to the charging structure without allowing the much larger Transco to dominate.

Powergen
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