National Grid Transco – Potential Sale of Gas Distribution Network Businesses

Comment on the Final Impact Assessment

16 December 2004

The Association of Electricity Producers welcomes the opportunity to comment on this impact assessment but has considerable concerns that this document should not be classified as a final impact assessment as there are a number of detailed issues that need to be developed to ensure the arrangements are consistent with the principles outlined.

We also have significant concerns that industry resources are being severely stretched by concurrent lengthy consultations and the sheer number of meetings that companies need to attend to maintain an overview of issues and contribute to their development. In practice few companies are able to resource all meetings and consultation responses are likely to be less well thought through than is appropriate for such important issues. This has been exacerbated by the delay in discussions of the exit reforms following the publication of the final RIA. The fact that these meetings only commenced just over two months before the Authority is to make a decision with respect to the sale and that these meetings are running in parallel with the consultation period for the final impact assessment demonstrates a complete disregard for industry concerns in this respect and compromises the regulatory process. This further reinforces our view that Ofgem is being opportunistic and is unnecessarily linking extensive exit reform with the DN sale. In our view this significantly increases regulatory risk that issues may not be adequately considered from all viewpoints, such that unintended consequences are overlooked that might give rise to inefficient outcomes and costs.

This response does not offer a simple recommendation on sale or no-sale; we expect individual Members will offer their views in their responses. It does however reflect the widely held views of our Members that are strongly felt, particularly in respect of the offtake arrangements, interruptions and flexibility arrangements, which we consider are unduly complex and unnecessary.

The key points of our response are as follows:

- The offtake and flow flexibility arrangements are insufficiently developed, with many parameters unknown, to enable the Authority to make an informed decision on the DN sale incorporating these arrangements at this time - in particular whether the identified principles can be achieved and benefits delivered.

- The offtake and flow flexibility arrangements should be decoupled from the DN sale process and be subject to a separate more complete impact assessment. This would mitigate the growing regulatory risk that arises from developing and implementing complex arrangements in dangerously short timescales.

- We recognise that new management practices and initiatives will drive the benefits that are likely to emerge from comparative regulation following the DN sale. However, the Authority will have to satisfy itself that those benefits have not been overstated and that, for example, efficiency gains arising from the separation of the LDZ price controls have been adequately considered.

Below we provide comments on the issues on which views are invited

Potential Benefits of DN Sales

Comparative Regulation

We agree that the introduction of comparative regulation could allow efficiencies to emerge that would lead to reductions in allowed revenues that may lead to lower charges to customers. The separation of the LDZ price controls from April 2004 was largely justified on the basis that it would allow comparators to emerge. This decision was made prior to Ofgem being required to undertake impact assessments, therefore the expected benefit was not quantified. We note that Ofgem makes a small allowance for this. However it is our view that if greater benefits had not emerged, and in the absence of a DN sale then Ofgem would have taken further action to properly establish comparators. Hence we consider the benefits arising from comparative regulation in a sale scenario may be overstated.

Independent Management Teams

We accept that the DN sale will introduce new management that is likely to result in greater efficiency savings than if the sale did not proceed.

Improvements in economic and efficient operation of networks

We do not accept that the proposed changes to the offtake, interruptions and flexibility arrangements are necessary for the sale to proceed. We consider that other less complex and costly options have been inappropriately dismissed and warrant fuller consideration.

From the business rules as currently drafted it is not self evident that Transco will receive better investment signals than it does at present. Shippers may not book long-term capacity, especially where they do not have a long-term relationship with the site. The investment signals may be less clear as shippers seek to avoid additional costs by booking a combination of short and long term capacity and flow flexibility products. Shippers will also seek to exploit arbitrage opportunities to trade between offtake points where the charges and exchange rates favour this. This situation is likely to be most acute in areas where the capacity costs are highest and the clearest signals are required to ensure investment meets customers' requirements.

In addition a number of important aspects of the regime are currently unknown these include, baseline quantities, charging methodologies and incentives on Transco. The absence of these key aspects of the regime makes it impossible to judge whether or not there will be improvements in the operation of networks.

Promotion of Competition

We agree that competition in wholesale and retail markets must be preserved following a DN sale. We do not however understand how the offtake arrangements which reside at the NTS / DN or direct connect interface will have any impact on wholesale competition which effectively takes place at the NBP (within the NTS).

Ofgem appears to consider that transparent pricing will promote wholesale competition yet prices will be less transparent and uncertain than they are currently when they are not dependent on the outcome of an allocation process and are published in advance. We also note that Ofgem has previously stated that cost reflective pricing promotes competition and we are unclear as to how pay as bid auctions are consistent with this.

Potential Costs of DN Sales

Shipper Interfaces

We agree that the establishment of an agency mitigates some of the cost that would otherwise have been incurred if the industry processes had fragmented.

Decision Making

We do not consider that the introduction of a price based regime at the NTS / DN interface can on its own ensure that the whole GB system is operated in a co-ordinated manner. Any commercial framework is likely to encourage parties to optimise their respective positions and it is difficult to see how the arrangements across the whole network can be optimised under such a regime. It is therefore likely that there will be some loss of efficiency. It is also the case that dialogue and negotiation will be in the interests of both parties in some circumstances.

Potential to Discriminate

The prevention of undue discrimination between networks, directly connected customers, storage and interconnectors has been a key issue for Ofgem throughout the DN sale process. Other interested parties have been less concerned about this and have felt that the risk of potentially being in breach of its licence would ensure that Transco did not discriminate between NTS connectees. These arrangements could easily be enhanced with the introduction of business separation and audit measures. The introduction of the proposed exit and flexibility arrangements continues to be a disproportionately complex solution and remains unjustified.

Whilst we accept that the same classes of users should be treated the same it is not clear whether it is necessary or indeed desirable to treat all connectees in the same way, particularly given their different offtake characteristics. In this regard an explanation of the difference between due and undue discrimination would be helpful.

In any case the NTS offtakes are not being treated the same in all respects, particularly with respect to the party that will have the contractual relationship with Transco NTS and be responsible for booking exit capacity and flow flexibility. At some points this will be shippers but at other points DNOs, this inconsistency is confusing and appears inconsistent with Ofgem's decision in respect of roles and responsibility.

Retail Competition

We agree that the avoidance of fragmented SPA arrangements will preserve retail competition.

Security of Supply

The ability to signal long term capacity requirements that should enhance a transporter's ability to invest to meet future demand will not in itself support or maintain security of supply. Depending on the baseline quantities, requirements for this to be released and trading arrangements shippers and DNOs may not book their full capacity in the long term, indeed there seems to be little incentive to do this unless incremental capacity is required, even if reserve prices are set at the same level for the long, medium and short term allocations. Hence investment signals may not be established. Any investment signals that are established with a three year lead time may not be simple to interpret, since the capacity and associated 'signal' could be traded to another location on shorter timescales.

It appears that Transco expects to comply with its 1 in 20 licence condition by providing **financially** firm capacity consistent with shipper and DNO long-term bookings. This may or may not be backed by physical investment. We consider that some regulatory oversight may be required here in addition to a consideration of whether sufficient capacity has been booked for 1 in 20 conditions, in order to avoid erosion of security of supply. thus regulatory costs may not be minimised.

<u>Other Issues</u>

Ofgem considers that competitive forces will ensure that any benefits are passed on to customers. However given the low level of benefits over such an extended time period, the net benefit being £225M in net present value terms from 2008/9 to 2022/23, customers are unlikely to perceive any benefit. Indeed initially customer tariffs may rise as shippers and suppliers need to cover the upfront costs associated with the sale, in particular the costs arising from the proposed reforms to the exit capacity regime and introduction of the flexibility product.

There are a number of elements of proposed EU legislation that the offtake and interruption arrangements do not appear to adequately address. In particular the provision of interruptible services, information on capacity, charging for demand side management services, the potentially discriminatory nature of pay as bid auctions and convergence of tariff structures. Ofgem has previously provided its views on these issues, however we do not agree with the interpretation of the legislation in these areas. We therefore consider that the proposed arrangements may be challenged less than a year after they have been introduced, potentially creating further uncertainty and cost, which would not be in the interests of customers.

We also have concerns that where shippers are booking capacity at NTS direct connects they may be governed by FSA rules and prevented from offering customers advice on various booking scenarios and their consequences.

<u>The Sale Option</u>

<u>Roles and Responsibilities</u>

The Association broadly agrees with the approach to the allocation of roles and responsibilities although we have some concerns that the offtake arrangements may not capture all the information required to ensure that investment in the NTS and daily operation is not optimal from a ‘whole system’ perspective.

<u>Offtake Arrangements</u>

The Association continues to believe that the introduction of the arrangements as proposed is not necessary for the DN sale to proceed, and that any such developments should be subject to a separate stand alone impact assessment. It is also the case that even though this is supposed to be the final impact assessment many of the details of the reforms are unknown, including; the methodology for determining baseline quantities for both capacity and flow flexibility; the methodology for determining reserve prices and the incentive arrangements. Until there is greater clarity on these important issues it will not be possible to assess how the arrangements will actually work and whether the desired outcomes will be realised.

The Association supports the principle that responsibility and accountability should be aligned and therefore those who need the capacity should be able to purchase the capacity and signal any requirements for incremental capacity. This is consistent with Ofgem’s decision to adopt option 2 for the offtake arrangements with NTS direct connects and DNOs having a central role in determining the NTS exit capacity they require. In so far as we are aware there has not been an open detailed discussion as to the issues that would influence whether direct connects or their shippers were to be responsible for booking exit capacity. Rather Ofgem seems to have decided in isolation that initially direct connects would book the exit capacity they require and then later that shippers should take on this role. At many NTS offtakes the shipper supplier and operator are aligned so they are indifferent as to which option is chosen. However at other offtakes more complex arrangements prevail where there are multiple parties. It is unfortunate that there has not been an opportunity to explore these issues more fully. It is only now that the business rules have been issued that additional issues seem to be emerging that could allow shippers to purchase capacity at one offtake and trade it to another potentially sterilising the capacity at the initial offtake or at least creating a risk that such capacity can not be made available. It is difficult to see how such arrangements that create risk and uncertainty and are likely to impose additional costs are in the interests of these customers, whose gas supply may be placed at risk.

The definition of nodal capacity rights on an annual basis would seem to be more aligned with the objective of providing clear investment signals than zonal or sub-annual products.

Allocation of NTS exit rights

Allocation of long term exit rights will only provide investment signals if users are in a position to determine and commit to purchasing capacity long term and do not subsequently trade the capacity to another location. So far little is known about how the baseline quantities are set, but it would seem reasonable to assume that for firm sites the baseline will not be less than the current registered capacity and that the quantities will reflect investment decisions to date. However if baseline quantities are set above this level then investment signals for incremental capacity are unlikely to emerge at all. Since it is expected that baseline quantities will be available dayahead it is difficult to understand why users would wish to book capacity long term unless they have a specific incremental requirement.

It is also the case that around 150 of the 180 NTS offtakes are effectively single user offtakes, hence in theory users will not be competing with each other for capacity. However since any shipper is allowed to purchase capacity at any direct connect offtake point it is possible that artificial competition might be created. Shippers may purchase capacity at cheaper offtake points with the expectation of being able to trade this to a more expensive location. Since trading can only take place a year ahead this might be a risky strategy for the shipper to follow but could give rise to some very misleading investment signals to Transco and significant additional risk and cost to customers. It could be argued that trading should be facilitated further out than just one year to allow shippers to manage their position and mitigate against distorted investment signals. In theory this arbitrage could be avoided if charges and exchange rates were set consistently between the 180 offtakes. Given the expectation that charges will be cost reflective and the exchange rates will relate to network capabilities it is difficult to imagine that all opportunities for arbitrage will be eliminated unless the charges and or exchange rates are ‘adjusted’ in some way. We consider these arrangements could give rise to undesirable inefficient outcomes.

Interruptions Arrangements

The proposals as currently defined demonstrate a considerable shift from customer choice to NGT choice over the sites that will be interruptible. It is also the case that the impact assessment and current business rules are substantially different in the way in which interruptible capacity is defined.

The impact assessment assumes that interruptible capacity will generally be available at the day ahead stage except perhaps on peak days. The business rules only anticipate unused firm capacity for that specific offtake being made available on a UIOLI basis. These approaches clearly result in very different quantities of capacity being offered. In our view UIOLI is not really an interruptible service in that it is simply a 'proxy' firm service, as it requires the capacity to have been purchased firm initially. This approach would not be consistent with the proposed EU gas regulation on access to networks, which requires TSOs to offer firm and interruptible services. We consider that the interruptible capacity available at the dayahead stage should be as defined in the impact assessment, so that all capacity is made available to the market and provides for efficient utilisation of the pipeline system. This would also seem more likely to provide compliance with the proposed EU gas regulation on access to gas networks.

<u>Governance of offtake arrangements</u>
The Association considers that it will be appropriate to incorporate the commercial elements of the offtake arrangements in the Uniform Network Code and for these to be subject to change control managed by the Joint Office.

<u>Diurnal storage</u>
The vast majority of responses to the initial RIA on the offtake arrangements did not support a commercial approach to the allocation of diurnal storage. However Ofgem decided that an administered approach was not appropriate given the risk of undue discrimination and the absence of the ability for users to signal the value they place on flexibility. As the risk and cost associated with these issues has not been clarified nor quantified we consider the proposed arrangements are a disproportionate response to the perceived potential problem.

In addition we consider there are important issues here; firstly that to date when the system has been operated on an integrated basis there has been no NTS investment specifically to provide additional diurnal storage capability over and above that which is consequential to investment in pipelines. If we assume the system is currently operated efficiently then going forward it might be reasonable to assume that if additional investment is required to provide diurnal storage capability that the system is being operated less efficiently than now or that Transco is failing to provide capacity consistent with its obligations and this should be investigated. Such circumstances could arise if incentives are set inappropriately and DNOs operate in their own interests rather than in a manner consistent with the system as a whole. Neither of these would be in the best interests of customers.

The flow flexibility arrangements as proposed are complex and will be costly for shippers and DNOs to monitor going forward. The disaggregation of the inherent system flexibility is a move away from the 'whole system' concept and will lose the economies of scale of Transco managing this on behalf of its customers. It is also unclear as to what action Transco will take in response for 'signals' for flow flexibility products. We are concerned that Transco will simply do nothing different than they currently do, efficiently sharing system flexibility between users as required and take rewards under any incentive scheme. Such an outcome would not be in customers' interests. We consider this is a prime example of an attempt to resolve a problem that is not actually a problem.

NGT's estimate of the costs of retaining a bundled product as referenced in paragraph 5.73 would be informative in this respect but this analysis is yet to be issued. A more balanced response to any possible discrimination would be to continue with the current approach and monitor the allocation and use of system flexibility then to address this when it becomes clear that investment specifically for diurnal storage will become necessary.

Short term arrangements

The industry has an expectation that the exit capacity arrangements will remain largely unchanged until 2008. Indeed it will be challenging to ensure shippers and direct connects are adequately prepared to participate in the long-term allocation of exit capacity and flow flexibility in summer 2005. This will be particularly challenging at shared supply offtake points where customers appear to be expected to establish contracts with shippers to secure capacity and flow flexibility.

Significant changes to the current arrangements from 2005 may well detract from efforts to establish an appropriate framework for long term capacity from 2008. It is also difficult to see what real impact any changes would have as this is within investment leadtimes and it would not be in Transco's interests to refuse sites from going firm or from increasing firm capacity.

A day in the life

This section provides a useful insight into how Ofgem envisages the arrangements will impact a number of different types of users and we agree this broadly covers the range of possible booking scenarios for each offtake type. However there are a couple of areas where Ofgem's description is at variance with the business rules as currently developed.

i) Ofgem states in paragraph 5.15 that dayahead interruptible capacity would occasionally not be available, for example at peak. This implies that interruptible capacity would generally be available at other times whereas the business rules only consider that interruptible capacity will be available when previously purchased firm is not being used.

ii) There are several references to firm capacity *to the extent that it is still available* being available on an annual basis or dayahead. Yet the business rules seem to suggest that baseline capacity (possibly plus additional capacity) will be made available down to the dayahead stage.

Business Separation

The Association supports Ofgem's revised pragmatic approach to business separation given the potential cost impact of full legal separation.

Governance Arrangements

The Association considers that the establishment of the governance entity and network operators not being allowed to 'opt out' from the arrangements should avoid inefficient fragmentation and the associated costs this would create. We also agree with the scope of the governance entity and structural separation. In managing the modification process and changes to charging methodologies this should avoid the potential for undue discrimination and provide transparency of process. However we have two concerns;

i) Ofgem appears to be considering a reasonable endeavours obligation to limit changes to charges to twice a year when it appeared to have supported once a year at recent DISG discussions.

ii) There is a risk of cost escalation in the future as the governance entity would need to recruit subject experts in order to be able to carry out it's role and yet the transporters are likely to also need such staff to develop the proposals in the first place.

Potential Competitive, Environmental and Social Impact

The Association has commented on the competitive impacts above.

With respect to the impact on the environment, we consider that Ofgem has overlooked the potential for Transco to operate its compressors differently than it does at present, particularly when it has contracted to provide flow flexibility. We would expect that there would be scenarios where Transco would need to trade off increased compressor running against buy backs of capacity or flow flexibility. At this stage it is not clear how this will be accounted for in the incentives.

With respect to income distribution, Ofgem notes that gas bills *have the potential to be lower than they would be in the absence of DN sales.* We are surprised that Ofgem is not more positive about reductions in bills, since this is the whole basis on which the sale is justified.

Risks and Unintended Consequences

The Association broadly agrees with Ofgem's assessment, but we would like to add the following comments;

i) Shipper's costs in respect of the offtake arrangements were based on incomplete information, given that there was no detail on the proposed arrangements at the time. We expect these costs to be significant.
ii) Customers were not asked to submit their expected costs
iii) The offtake arrangements may not work as intended. If shippers and DNOs do not book long-term capacity and in the absence of a planned approach, ultimately security of supply in the gas and electricity sectors could be placed at risk.

Analysis of Benefits

Benefits from Comparative Efficiency

The Association accepts that the largest portion of expected benefits are anticipated to arise from comparative efficiency at subsequent price control reviews.

There are however a number of uncertainties and it is not clear whether or how these have been considered. The gas industry was privatised before the electricity industry and has therefore been subject to price controls for a longer period of time, hence it may not be appropriate to draw a comparison with efficiency gains achieved by distribution companies as the starting point was somewhat different. In this context we note the findings of the report by Parker and Martin as referenced in Appendix 6, that says better performance would have been seen in the gas industry had more attention been paid to the structure of the industry at privatisation. However no further information is provided to judge this by.

This said we do agree that economies of scope should exist and emerge particularly for those DNs purchased by companies with interests in other utilities with regional overlap.

We also accept that the exogenous approach is more straightforward than the endogenous approach, but consider both approaches are somewhat prescriptive and high level in determining the potential improvements in controllable operating expenditure.

The Association also agrees that a bell shaped profile for benefits is more likely to represent the manner in which benefits could accrue rather than a flat profile.

Benefits from framework of arrangements

The Association agrees that the definition of roles and responsibilities and agency and governance approaches are largely cost mitigation measures rather than measures which create benefits in their own right.

We note that the base case for the offtake and interruptions arrangements is the continuation of the new arrangements under a divested industry structure rather than a no-sale scenario as is the case for the benefits arising from comparative regulation. This inconsistency is curious and distorts the analysis.

The use of the number of ticks to establish qualitative benefits is highly subjective and is not robust to alternative viewpoints. Indeed anyone looking at this document who has not been closely involved in the process to date would question why Ofgem has not challenged Transco for being in breach of its licence.

The Association considers that:

- Under any set of arrangements Transco would be at risk of being in breach of its licence if it were to discriminate, and this is likely to prevent this behaviour
- Freedom to contract on market based terms is an Ofgem desired outcome rather than something that customers are demanding
- Network operators currently receive clear investment signals from customers opting for firm transportation, the new arrangements will provide for less clarity in these signals
- The new SO incentive arrangements have not yet been published nor discussed in any detail therefore it is not possible to comment on these fully. However it seems likely that the new arrangements will provide Transco with more tools and options for addressing network problems, this will result in more complex decision making for Transco and additional challenges for system users trying to monitor Transco's actions. It is also possible that Transco may be able to arbitrage between incentives. As such it is not certain that the SO will make more efficient decisions.
- Ofgem seems to consider that the new arrangements will provide customers with greater choice, in some respects this is true in that customers who wish to try and establish an interruptible arrangement will not be limited to the current 45 day contract. However as the decision over whether sites are interruptible or not resides with Transco this represents a shift from the current arrangements where the choice resides with the customer. In this respect customers will have less choice.
- Competition in gas supply is well established in the UK, it is not clear how Ofgem considers this will be enhanced. Rather it is important that the arrangements do not have a detrimental impact on competition.

Quantified Benefits

Ofgem estimates that the offtake and interruptions arrangements will give rise to benefits estimated to have a NPV of £17.4M. This is divided between more efficient investment, £8.5M and reduced balancing costs £8.8M.

Taken together Ofgem estimates that the offtake and interruptions arrangements will deliver savings of 6.5% of NTS capex on an annual basis, particularly at direct connects. This number is not supported. In respect of this we make the following observations:

- Investment for existing firm offtakes has already been incurred.

- Given the uncertainty surrounding interruptible capacity, the arrangements seem to pushing customers towards firm capacity that would increase NTS capex.
- The NTS is due to retain a 1 in 20 obligation and may therefore need to invest even if no long-term signals are received

Ofgem also expects gas and electricity balancing costs to reduce by 1%; again this value is not substantiated. We consider the assumptions on which this is based to be seriously flawed.

- Parties that purchase flow flexibility are likely to use it actively to recover the costs involved
- NGT may have to take additional balancing actions in order to meet its contractual commitments with respect to flow flexibility.
- The initial allocation is expected to be based on the local network capability and location rather than necessarily to those that value it most, it therefore does not follow more flexible and efficient plant will acquire the flexibility and offer it at lower cost to the electricity balancing mechanism.
- Transaction costs may prevent efficient trading of flow flexibility
- Allowed revenues are fixed and as such CCGTS who seem to be expected to be significant purchasers of flow flexibility will pay a greater proportion of TO exit costs than they do now, it therefore does not follow that electricity balancing costs will fall.
- Flexibility offered into the balancing mechanism is likely to be at higher cost that now to cover the risk of flow flexibility overruns or risk of not being able to purchase sufficient flexibility in the short term.
- Alternatively flow flexibility may be withheld from the Balancing Mechanism if CCGTs are unable to secure flexibility at reasonable cost and the overrun regime imposes penal charges.

<u>Analysis of Costs</u>

The Association considers that the process of inviting shippers to provide estimates of their costs was a positive initiative in the DN sale process. We are however concerned over the timing of this information request, given that a significant proportion of the costs shippers might face could arise from the offtake and interruptions arrangements which were insufficiently developed at the time and still lack clarity in a number of areas. Hence shippers would have been unable to provide robust information.

We also note that customers, particularly those directly connected to the NTS were not asked to provide estimates of the costs that they will incur. We consider the estimate of £2,000 per site significantly underestimates the costs of putting in place new commercial arrangements to ensure shippers book adequate capacity and flow flexibility and do not trade it on. In addition contracts may need to be renegotiated, which would incur further costs. Ofgem seems to assume that customer and shipper costs are interchangeable yet in establishing new commercial arrangements or renegotiating existing supply contracts both parties will face costs.

It also appears to be the case that NTS direct connects will incur costs and yet benefits will largely flow to DN connected customers, leaving NTS customers facing a dis-benefit from the sale.