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

Final Impact Assessment

Response by E.ON UK

Overview

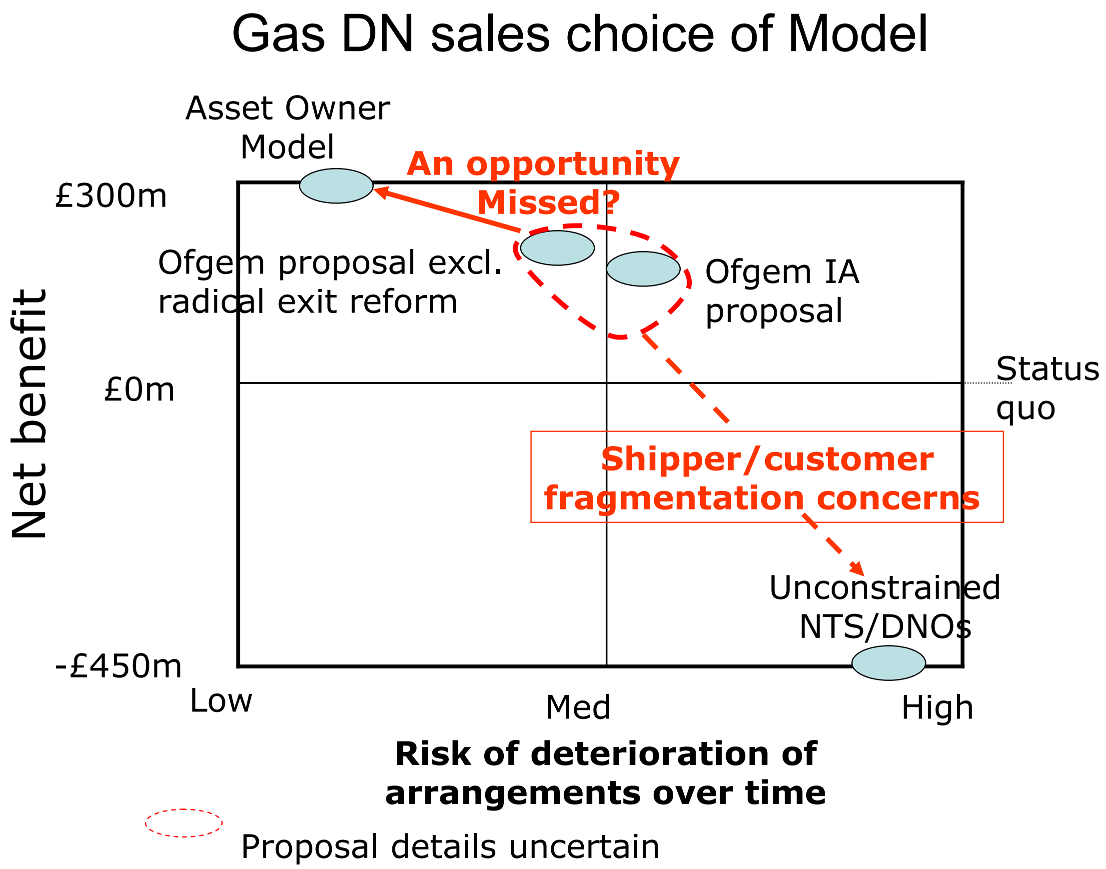
E.ON UK offer qualified support for the sale. Overall the costs and benefit values outlined in the document seem broadly reasonable. Nevertheless we do not consider the proposals as described offer the best prospect for maximisation of benefits to customers over the longer-term.

The impact assessment states that some 95% (£309m base case) of the benefits are likely to originate from comparative regulation, whilst 5% (£16m base case) of the benefits come from changes to the commercial arrangements. It is however, the changes to the commercial arrangements that cause most of the additional costs (£102m base case) to shipper-suppliers. Logically customers' interests would be best served by focusing on arrangements that largely keep the current contractual arrangements between Transco and shippers whole, saving most of the £102m costs but losing £16m of the theoretical benefits. E.ON UK as Powergen outlined how this might be achieved in a paper entitled "Lessons from BETTA", presented to the Development and Implementation Steering Committee (DISG) on 3 February 2004.

Adoption of this genuine 'business as usual' approach would have avoided many of the complexities and risks associated with having to change codes, processes, systems and interfaces and significantly reduced the risk of inefficient fragmentation of the arrangements particularly the adverse impact this could have on competition in shipping and supply. Under this model Transco would simply be selling some of its assets, which in future would be managed 'behind the scenes' by a new owner.

Ofgem have not sought to pursue this approach, but instead focused on measures to mitigate shipper costs whilst not constraining buyers in how they operate their newly acquired assets. In this regard, the safeguards developed by Ofgem in conjunction with the industry reduce the likelihood of day 1 fragmentation of rules, processes, and charging arrangements, including independent and transparent governance, a relatively broad agency and national co-ordination of charging methodologies are to be commended. Delivery of these aspects of the project are absolutely essential, if we are to avoid the risk of rapid escalation of shipper costs, which might otherwise dwarf the theoretical but uncertain benefits from comparative regulation. In particular any future break-up of common agency activities with each distribution network owner (DNO) managing settlement process within individual networks might lead to costs at high as £730m (the full fragmentation scenario described in the Gas Forum OXERA Cost Study of May 2004).

E.ON UK remain concerned that Ofgem's continued insistence on radical reform to the exit and interruptions regime as a pre-condition of the sale will place further unnecessary costs and risks on shippers. It may even delay implementation of the sale. We believe Ofgem should instead refocus its efforts on Option 1 the administered approach outlined in the Offtake Arrangements regulatory impact assessment (RIA), which was widely supported by shippers, customers, Transco and potential buyers alike.



The above diagram seeks to summarise our views on the net benefits of a number of distribution network (DN) sales options, including that described in the final impact assessment (IA) with and without radical exit reform, an asset owner model and a worst case scenario if inefficient fragmentation emerges over time. Our detailed response to comments and questions posed in the document are set out below. For completeness our responses to recent specific issue RIAs are attached in Appendices A, B and C.

Options
Allocation of Roles and responsibilities

Of the options presented in the original Roles and Responsibilities RIA, we preferred Option 3, rather than Option 1 described in this IA. In our response to this RIA (Appendix A) we described how we believed this option best mirrors the organisation of activities and the split of decisions taken centrally or locally within the current Transco business. In our view most of the benefits from DN sales can be achieved through better asset management, where there is perhaps most scope for improvement. We would have preferred the NTS SO to continue to take lead responsibility (as it does now) for system operation across the transmission and distribution systems. In our view the marginal gains that might be realised through DNOs actively managing system operations within each DN, especially if this in turn leads to DNOs seeking to establish different regional market rules and charging methodologies make this a much higher risk option.

Offtake Arrangements

The details of the proposed exit reforms are still emerging. It is therefore difficult to comment with much accuracy on the impact of such proposals on shippers and customers without knowing the form of the exit auctions, the transporter incentives, the service obligations and the likely level of charges for both primary capacity and within-day flexibility. In our response to Ofgem’s most recent shipper cost questionnaire in August 2004, E.ON UK estimated costs for extra administration for managing our direct connect customers largely based on managing auctions for primary National Transmission System (NTS) exit capacity, but did not envisage the extra complexities associated with managing the trading of such capacity or booking and monitoring within-day capacity and flexibility. We therefore believe it is appropriate to double the estimates of our additional costs for dealing with new offtake regime submitted to Ofgem in August 2004.

It is extremely disappointing that Ofgem continues to make radical reform to the exit reform a condition of the sale despite widespread opposition to such reform by customers, shippers Transco and potential buyers. Transco are only pursuing this matter because they have little choice as the sale might otherwise be prejudiced. Nevertheless the long-term impact of the proposed changes on shippers and their NTS direct connect customers could be quite profound. Indeed some of the changes such as the new flexibility product seem to be a ‘repackaging’ of a ‘linepack service’, something which was widely opposed by the industry as part of previous discussions on shorter gas balancing periods.

Specifically we have difficulty with Transco seeking to implement rule changes on the basis that shippers may engage in particular behaviours, even though there is no evidence presented to suggest they would. The proposal for hourly overruns is a case in point, because it is proposed initially to set hourly overruns to zero. If such an ‘incentive’ regime were ever considered necessary it should be brought forward as a proposed modification to the UNC.

In seeking to reform the exit regime Ofgem seem to be focusing on concerns about undue discrimination between NTS connectees, and considers the introduction of market mechanisms for the allocation of exit capacity will provide significant benefits particularly in terms of providing market signals to network operators for investment in their respective systems. We are not aware that customers are greatly concerned about the potential for undue discrimination between NTS connectees. As a major power generator with a number of stations supplied from to the NTS we would have been satisfied, at least for the period of the current price control, to rely solely on Transco's original offtake proposals (Option 1) which would have applied restrictions on how DNOs would book capacity or offtake gas from the NTS. Such relatively simple 'interface' arrangements combined with a high degree of information transparency and robust internal separation procedures would in our view have offered the lowest cost solution.

In each of our recent regulatory impact assessment responses we have stressed the importance of making, more relevant comparisons in relation to undue discrimination, i.e. no undue discrimination in the terms offered to customers simply on the basis of the system they happen to be connected to. Implementation of the proposed exit reforms set out in the IA will mean that NTS connected customers will face a much harsher operational regime than similar customers that happen to be connected to a DN. It is this undue discrimination between 'real' customers that is much more important than interface arrangements in the middle of the supply chain between two, tightly regulated, monopoly network operators. These matters were described in detail in our response to the Offtake Arrangements RIA (see Appendix A).

E.ON UK is happy with the current arrangements for the sale of 'bundled' NTS transportation services. Our generation investments were made on the expectation that access rights would continue to be made available on broadly similar terms as now, provided we continue to book capacity year on year. Transco sized its system (within restrictions set out in Network Exit Agreements) to allow us as an end-user to offtake gas at rates up to a value equivalent to a daily quantity divided by 24. At firm sites these 'rights' are backed-up with Transco's 1 in 20 obligation. We therefore find it hard to understand how Transco believes it can replace these broadly satisfactory arrangements with uncertain auctions for the allocation of primary capacity combined with separate within-day flexibility product. We also don't understand how the costs of theses separate products can be easily separated or accurately targeted at particular users.

We agree with Transco's previously stated view that within-day flexibility is essentially a by-product of investing in primary system capacity. As such it makes sense for users to continue to buy the product in the existing 'bundled' form where they are allowed to flex under the maximum booked flow rate. It is also inconsistent to require those offtaking gas to buy a flexibility product, whilst those delivering gas into the system continue to be able to flex under their maximum booked flow rated product. Despite claims that the NTS system is designed to be operated 'flat' it is in fact the case that flexibility is built in at both entry and exit. In reality it is neither worthwhile to seek to allocate within-day flexibility at either entry or exit and it is best to continue to 'bundle' flexibility within the maximum daily quantity (MDQ).

As a generator our primary focus is generating electricity – we are not in the business of seeking to optimise our capacity and flexibility product bookings especially given gas transportation costs represent such a small proportion of our input costs. Our objective is to obtain a high degree of certainty that we can obtain gas as and when required.

Ofgem put great emphasis on the importance of new exit arrangements to ensure economic and efficient network operation and development. In seeking to achieve this Ofgem should not inadvertently create greater uncertainties for NTS direct connects. Although established players will no doubt learn to live with the arrangements (they have little choice) new connectees could be put off investing if the reliability of any new supply is potentially threatened by these new arrangements. Less CCGT investment could affect electricity security of supply and the building of new storage facilities (which will be essential for maintaining UK supplies during winter periods in future) could be hindered.

Ofgem have stated that benefits will accrue from more efficient gas balancing. This seems to come from more rigorous enforcement of gas offtake restrictions at NTS direct connects or DN offtakes. This suggests that current arrangements are significantly sub optimal. Deviations from allowed flow rates at NTS direct connects, are in fact already carefully monitored by Transco and tight restrictions (ramp rates and rate change notice periods) that reflect system limitations are imposed. With prior permission from Transco users can have some leeway to vary flow rates more quickly but Transco does not allow this if it has concerns about its ability to residually balance the system.

These arrangements work well, with flexibility being made available if feasible. Thus we are highly sceptical about Ofgem's suggestions that balancing costs might be reduced in both the electricity and gas markets. Indeed we believe the exact opposite may result. Reducing gas demands through indirect buy-back of capacity is unlikely to be as certain or as effective at reducing gas demand through direct purchases of gas at particular locations on the on-the-day commodity market (OCM). Equally requirements for users to effectively purchase within day flexibility 'in advance' (under threat of both hourly and daily flexibility overruns) will introduce rigidities into the decision making processes of Transco and Generators, which may restrict the ability of parties to offer electricity into the short term electricity spot market or balancing mechanism.

Ofgem ascribe a £8.8m NPV benefit for reduced electricity and gas balancing costs with the introduction of new offtake arrangements. In the light of the rigidities we believe will be introduced into the regime from the proposed changes, we consider a negative NPV impact of say -£5m is more realistic. This is one of the reasons we consider the option that excludes radical exit reform offers more net benefits to customers than the option including such reform (see diagram in the overview section if our response above).

The industry has been looking at reform to the exit regime for a number of years ever since Transco agreed to a transportation licence condition to seek to introduce a universal firm exit regime (which we understand is shortly to be removed from Transco's licence). Ofgem and the industry focused much effort on working up proposals that might be acceptable, stopping short of the introduction of a universal firm regime but recognising some incremental changes to the interruptions regimes would be desirable.

Much of the thinking behind these latest exit reform proposals revisit the lengthy debate that was had on creating a universal firm exit regime. In short we believe that if the exit reform outlined in the IA were not linked to the DN sale project, but were to be considered on a stand-alone basis Ofgem would have great difficulty demonstrating net benefits. In addition many practical details of the arrangements have yet to be resolved. Consequently, we urge Ofgem to resubmit its final IA using instead the administered (Option 1) offtake arrangements originally proposed by Transco.

Agency and Governance

Of the options considered by Ofgem we most favoured Option C (see our detailed response to the Agency and Governance RIA in Appendix A). Given this is the option Ofgem has adopted in this IA it is not surprising that we welcome these proposals. Nevertheless the devil is very much in the detail.

Successful implementation of these proposals will be crucial to mitigating the costs faced by shippers. In particular the governance arrangements must be nominally independent, no longer dominated by Transco and instead managed for the benefit of all Network Code Parties. In this regard it is frustrating that Transco has chosen not to constructively engage in parallel discussions of shipper modifications which seek to improve Network Code Governance, preferring instead to use the Uniform Network Code (UNC) development forum as a vehicle for its proposals. Our fear is that many of the Option C governance proposals may be watered down by Transco with controls and management of these arrangements enshrined in documents that can only be changed by transporters.

Particular concerns include the Joint Office rules seeking to deal with matters that are rightly covered by the Modification Rules and anything that may result in the diminution of the rights of shippers to propose changes to transportation arrangements at any point along the supply chain from 'beach to meter' (including offtake arrangements). Other matters that need to be satisfactorily resolved include, inclusion of ungoverned services where appropriate in the UNC, proper oversight of relevant code ancillary documents by the (Uniform) Network Code Committee and joint (meaning including shippers) industry governance of changes to the agent's (xoserve's) central settlement processes (i.e. UK link, Gemini etc). We have also yet to see a detailed process plan of how xoserve intend to implement Option C agency arrangements. Although many of these issues have been discussed in the UNC development forum this is a Transco process driven by Transco's agenda (rather than an 'industry' Network Code process). It is therefore difficult to get Transco to take shipper's concerns seriously where their views are odds with users.

We are pleased that Ofgem took on board shipper-supplier concerns with regard to the agency and governance arrangements and in particular prevented the fragmentation of the AT link settlement processes (under Transco's original proposals), which would have potentially caused huge problems for shippers. We trust Transco will fully implement Option C as set out in the IA.

Risks and unintended consequences

In our response to the most recent Ofgem shipper cost survey we emphasised our view that the chosen allocation of roles and responsibilities, in which the DNOs would be responsible for all system operation activities within their area, would act as a strong driving force on DNOs to seek to fragment market rules, charging methodologies and processes. We don't think this will necessarily happen straight-away as DNOs will naturally be focusing on activities where they can maximise efficiency gains (i.e. in the area of asset management) rather than providing new 'innovative' services to shippers and customers. Nevertheless the motivation for DNOs to optimise their daily operations at shippers' expense exists. We suggest that even under full and complete implementation of Option C agency and governance arrangements our costs could increase significantly in the absence of robust regulatory oversight resisting further fragmentation. If our assessment of this risk were to be reflected across the whole market an outturn NPV cost greater than £250m might be a credible outcome. Please refer to E.ON UK's shipper cost survey submission of August 2004 for further details.

Ofgem have responded to shipper concerns by seeking to introduce new licence safeguards, such as, a) a requirement for DNOs to sign onto the agency arrangements and seek Ofgem permission before 'going it alone', and b) the coordination of changes to charging arrangements with other transporters. These safeguards are welcome, however history demonstrates that, despite the best intentions of all involved, market arrangements tend to get more complex and fragmented over time. It takes a concerted effort by decision makers to resist this trend. That is why we support Ofgem in its efforts to establish more transparent and independent governance of the UNC. It is this governance framework that should provide the 'glue' to hold the UNC, short-form codes, offtake arrangements and charging methodologies together – or at least we hope so!

Another significant potential risk to the industry, which is extremely difficult to quantify at this stage is where does implementation of within-day flexibility arrangements take us? Is it the first stage on the 'slippery slope' to the introduction of hourly gas balancing. Seeking to allocate or charge for transportation services on an hourly basis at exit, logically might be applied in concept at entry. That would require real-time entry allocation and attribution arrangements and before we know it the industry will end up having to spend millions of pound renegotiating gas contracts and changing the whole way in which the industry does business.

Will the establishment of exit capacity auctions introduce yet more volatility into the year-on-year level of NTS charges (as already happens at entry)? What affect will this uncertainty have on customers and will this adversely impact competition between gas suppliers? Will shippers on behalf of customers really be willing to book long-term exit capacity? If not how will Transco get its investment signals? Why would someone wish to replace a 'physical' offtake right that will be there from year to year provided he rebooks, for a long-term obligation to book a 'financially firm' capacity product that may not be there when needed? Perhaps a solution to 'guaranteeing' physical rights is to define exit capacity in terms of a firm pressure commitment for the relevant period.

Another area that causes us great concern is Ofgem's intention to introduce conditional licence conditions on DNOs to seek to establish further reforms to the interruptions regime within DNs as per Standard Special Condition D8. We consider that such reforms are likely to introduce further significant costs for shippers (this was described in greater detail in our response to the exit and interruptions RIA). Given the conditional licence condition will be introduced on the back of the DN sales project it is logical that estimated costs and benefits of such a reform should be included in the final IA for the DN sale. Alternatively Ofgem should withdraw the conditional licence condition and allow any such reforms to emerge if the industry sees fit to propose such changes in future.

There are also a number of procedural and process risks to the project itself. The tight timescales and the financial imperatives mean that Transco will continue to force a rapid pace and probably cut corners in the process. Discussion on both the UNC and exit arrangements are for example taking place outside established formal industry processes. This means that the modification that sets out the demise of the Network Code and transforms it into the Transco short-form code may be presented at the 'eleventh hour' leaving little time for the industry (and in particular parties that are unable to attend Transco's UNC and exit meetings) to be formally consulted.

In addition Ofgem may have exceeded its powers in seeking to establish the new private collective licence modification procedures without reference to statutory procedures (Appendix D sets out a legal view on this matter obtained by the Gas Forum). Each of these matters may make Ofgem's determinations on modifications and licence conditions open to challenge.

Cost and Benefits analysis

As a shipper we have not seen it as our role to make the case for or against comparative regulation particularly because such theoretical benefits are very difficult to prove one way or another. This case must be made by Transco and the potential buyers. The Ofgem benefit analysis however, doesn't seem unreasonable particularly given that its conclusions sit between the detailed analysis commissioned by the sellers on the one hand and a sceptical shipper on the other hand. What is apparent is that it will be very difficult to prove one way or another, whether Ofgem's performance in capturing the theoretical gains of comparative regulation for customers will actually be realised. Given this uncertainty on the benefits side it makes sense to us to focus on establishing a post DN sales regime where increased shipper costs which will in turn ultimately be passed through to customers are kept to an absolute minimum.

The conclusions reached on the base case costs seem reasonable although, as stated earlier we consider the costs of the offtake/exit reforms are likely to be understated, given that the complexity of the primary and within-day flexibility products that are emerging are greater than expected. We suggest doubling the NPV shipper costing for this aspect of the arrangements. However, given most shipper costs relate to cost to serve mass market customers rather than NTS direct connects the overall increase in base case costs is likely to be small.

Looking at the various findings of the ILEX report, the OXERA Gas Forum report and the more recent Ofgem shipper cost study provides a high degree of confidence in the IA cost estimates. The early ILEX study didn't really reflect shippers concerns about fragmentation nor were the details of Transco's proposals fully known, the OXERA report reflected these concerns (hence the very high cost full fragmentation scenario), but suggested costs could be kept to a level similar to those of the ILEX report with the right agency arrangements, and the latest detailed Ofgem study (based on a larger sample) perhaps reflects a fuller and more realistic assessment of the costs of risks. Even with high levels of uncertainty associated with estimating shippers costs the cluster diagrams on page 139 of the document provide a high degree of confidence as to the likely robustness of the estimates.

Cost-benefit conclusions

Ofgem have clearly put a lot of thought into the cost-benefit analysis, and the results are both sound and realistic given the assumptions made. In our view, however, a number of mistaken assertions and beliefs lead to policy choices that diminish the benefits that might otherwise be realised by customers.

It remains our view that in accordance with the terms of reference that Ofgem established for itself at the start of this project (the first Development and Implementation Steering Committee (DISG1)), the focus should be on what is 'expedient and necessary' to facilitate the sale. In our view the following approaches would be more consistent with this criterion:

- Firstly a structure could have been established to keep as far as possible the current contractual arrangements between Transco and shipper's whole. This might save £102m base case costs but lose £16m NPV base case benefits from changes to the contractual arrangements.
- Secondly implementation of Transco's original administered offtake arrangements is the best way forward. Discrimination concerns between NTS conectees are not great but could have been satisfactorily dealt with through information transparency, robust internal separation arrangements and normal regulatory oversight of monopoly businesses.
- Thirdly within-day flexibility products are not required for efficient system operation. We consider that rather than reducing gas and electricity balancing costs by £8.8m (as stated in the RIA) costs may increase by say up to £5m, reducing net benefits to customer by about £14m.
- Fourthly we estimate our costs for managing our NTS direct connects would be double that originally submitted to Ofgem under the latest shipper cost survey.

With changes to the above policy choices it would seem feasible for over £300m net benefits to be realised by customers.

Peter Bolitho
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E.ON UK
16 December 2004

Attachments

The following documents are attached as separate documents

Appendix A	Response by Powergen to Regulatory Impact Assessments a) Allocation of roles and responsibilities between transmission and distribution networks b) Agency and governance arrangements
Appendix B	Response by E.ON UK to Offtake Arrangements Regulatory Impact Assessment
Appendix C	Response by E.ON UK to the Interruptions Regulatory Impact Assessment
Appendix D	Gas Forum legal view on the process for establishing the new private collective licence modification procedure.

Please note these documents are submitted as separate electronic files