Sonia Brown
Director, Transportation
Office of Gas and Electricity Markets
9 Millbank
London
SW1P 3GE

Head Office
Inveralmond House
200 Dunkeld Road
Perth
PH1 3AQ

Telephone: 01738 456400
Facsimile: 01738 456415
email:

Our Reference:
Your Reference:

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Dear Sonia

National Grid Transco – Potential Sale of Gas Distribution Network Businesses
Final Impact Assessment

We welcome the publication of the above final impact assessment and the opportunity to comment on Ofgem's conclusions on the costs and benefits associated with the potential sale of NGT's gas Distribution Networks (DNs).

We agree that there is potential for substantial net benefits to customers to be realised by the proposed DN sales. As described, the proposed sale will allow Ofgem to compare the performance of independently owned distribution networks and we would broadly concur with the estimates of the gross benefits that Ofgem put forward in the paper.

The value of comparators in setting price controls was most recently illustrated in the electricity price control final proposals, published at the beginning of December. In calculating allowed operating costs as part of the electricity distribution price control, Ofgem assessed the relative efficiency of the Distribution Network Operators (DNOs). The resulting regression analysis showed that the industry efficiency frontier was set by Southern Electric Power Distribution (SEPD), a SSE company. The operating costs of the entire electricity distribution industry were then set on the basis of the difference between the industry average operating costs and the costs of SEPD as the frontier company.

It is possible to assess the benefit of comparative regulation by re-running the efficiency assessment without SEPD. That is, if the efficiency frontier had been set by a company other than SEPD. Our own analysis has shown that if the identical methodology had been used by Ofgem, but excluding SEPD from the efficiency assessment, then operating cost allowances would have been around £19m a year higher across the industry. Thus, the fact that SEPD set the efficiency frontier, rather than the next most efficient company, has saved customers around £19m a year. This is, therefore, an example of the tangible benefits for customers that can arise as a result of comparative regulation.

Discounting the £19m p.a saving in perpetuity at the regulated cost of capital would indicate an NPV of comparative regulation for customers of around £275m from the current electricity price control. It should be noted that this is the benefit to customers of just one price control review using comparative regulation. It is therefore a conservative proxy for the wider benefits of comparative regulation.

It is also interesting to note that the above analysis of actual benefits of comparative regulation within the current electricity sector produces similar levels of benefits to Ofgem's analysis for gas, which further supports the assessment that the sale of the gas DNs has the potential to produce a significant net benefit to customers.

Turning now to the structure of the proposed commercial and regulatory regime to facilitate the sale of one or more DNs. Ofgem and the industry have spent considerable time and effort to ensure that, as far as possible, any cost and complexity that may arise following a sale is minimised. In the main, we support the approach that has been adopted to mitigate these risks, for example, the proposed Agency and governance arrangements and the establishment of a Uniform Network Code.

However, we are very concerned that the proposed NTS offtake arrangements are unnecessarily complex and may ultimately undermine the level of net benefits identified by Ofgem to date. In particular, we believe that the proposed flexibility product adds substantial complexity and risk to the gas wholesale trading arrangements, the impact of which has not, in our view, been adequately assessed at this stage and which may, therefore, add a risk of unintended consequences. Furthermore, we believe that the complexity of the arrangements could pose a real threat to the completion of the sales process within the allotted timescale.

<u>Rational for the proposed flexibility product</u>.

We understand that there are essentially three issues that the flexibility product is seeking to address.

1. <u>NTS operational concerns</u>. NGT is concerned that future DN owners *might* operate their systems in a manner that could lead to operational difficulties for the NTS. We understand that currently, internal processes ensure that the NTS limits a DN's access to NTS flexibility if, and when, such limitation is required. They have therefore argued that following the sale, some sort of formal control mechanism would still be required since the internal processes would no longer be appropriate. It is on these grounds that an unbundled flexibility product has been proposed and NGT has presented information at recent DISG and Exit Reform Forum meetings to support its proposals in this respect. However, apart from demonstrating that both NTS directly connected customers and DNs make use of the inherent NTS flexibility, Transco has not, as far as we can see, presented evidence of materiality to justify its extremely complex proposals.

   Therefore, to the extent that the operation of the NTS could be materially jeopardised by users of NTS exit capacity, we see no reason why, at this, stage this concern could not be addressed through simple, enforceable and transparent offtake rules that could be contained within the proposed Offtake Arrangements/NeXAs or the UNC.

2. Discrimination. Ofgem is concerned that, following a sale, the NTS will favour the RDNs in the allocation of NTS flexibility (to the extent that it is available) and, therefore, a fully commercial arrangement is required to ensure that this does not take place. While there may be a potential risk that the NTS could behave in this way, we believe that there are other, less complex remedies to mitigate this risk. For example, we believe that this risk could be addressed by rigorous NTS/RDN business separation and non-discrimination requirements within the licence, plus a licence requirement in respect of auditable trails of the allocation of flexibility. Again, we believe that an appropriate level of control could be designed and incorporated within the relevant documents and any breach by NGT would be subject to licence enforcement action and associated financial penalties.

   Ofgem is also concerned to ensure that NTS directly connected supply customers and the DN connections are subject to the same arrangements to ensure that there is no risk of discrimination between these two categories of NTS connectee. In our view, NTS directly connected supply points are very different entities to large distribution networks that are ensuring the transportation of gas to, and securing the supply of gas for, millions of customers. We therefore question whether there is in fact an issue of discrimination when the two categories of "user" are so entirely different.

3. Efficient investment. We understand that Ofgem is of the view that unless there is a commercial regime and associated incentive to allocate NTS flexibility, there is a risk that DNs will not make an efficient trade off between the "cost" of using NTS flexibility and the cost of investing in flexibility within their own networks. However, NTS flexibility is a by-product of the NTS investment that has already been funded through the existing NTS price control mechanism. Furthermore, NGT has confirmed that it has never invested for NTS flexibility.

   In other words, flexibility is not a discrete component of the NTS asset base. It is inextricably linked to the existing, and future, NTS asset investments. We therefore fail to understand how an accurate, cost reflective price could be determined for an unbundled flexibility product to enable a true "trade off" to be achievable. Perversely, we believe that there is a significant risk that the extremely complex regime that is proposed for the product will actually result in an increased inefficiency in the use of the NTS since "users" will seek to avoid the regime altogether.

Other issues associated with the proposed flexibility product

As a consequence, we do not believe that a sufficiently robust case has been put forward to justify complex and extensive reform of the offtake arrangements. Moreover, we believe that such reform would result in significant new problems and issues, in particular:

- **Risk to market participants:** NGT's proposals include a requirement for DNs and NTS direct connects to purchase ahead of the day its anticipated use of the diurnal storage on peak and non-peak days. However, the actual requirement will not be known until the end of day quantity has been determined some x-days after the event. This "ex-post" arrangement would seem to provide a user with little control of the flexibility costs it would be exposed to. Charge risks would be further exacerbated by the proposed overrun charges and experience to date of a "ticket to ride" regime would suggest that these are likely to be penal in order to provide the "appropriate" commercial incentive on users to buy the product in the first instance.

  A further financial risk of the proposed commercial regime is associated with the treatment of any under/over recovery for allowed revenue that might arise from the action allocation mechanism and the treatment of revenue that overrun revenue. It will be essential to ensure that neither of these introduce a distortion to the market. Furthermore, given the interaction of these treatments on the purchasers of the product, it will be essential to ensure that these mechanisms are established before the initial allocation of exit capacity

- **Pricing of the flexibility product:** As we have already indicated, cost reflective pricing of the flexibility product and associated overrun charges will be critical if accurate trade-offs are to be made and the future efficient use of the NTS is not to be compromised. However, we are unsure how it will be possible to ensure a cost reflective pricing methodology for flexibility that is to be allocated at a known price ahead of the day. This is because we understand that the amount of flexibility that is associated with the network not only relates to the physical assets but also how the system is configured and operated on any particular day. A further aspect that will need to be considered is the use of flexibility by the NTS itself for system energy balancing purposes. That is, how its "own use" will be accounted for?

- **Impact on the electricity market:** We are concerned that very little analysis has been carried out on the impact of the proposed flexibility regime on the electricity market other than establishing that gas fired generators that participate in the electricity balancing mechanism will be required to purchase the product. In our view, it is most unlikely that these participants would be in a position to identify well in advance what their likely requirement might be due to the short-term nature of the electricity balancing regime. We therefore believe that before any such change can be considered, it is essential to ensure that it would not have a detrimental impact on that market since customers will, either directly or indirectly (due to the impact on competition), bear the cost.

- **Security of supply:** It is also vital to ensure that the new arrangements do not have a detrimental impact on security of supply in either of gas and electricity markets. We have already indicated that we believe the product will have an impact on gas fired generators that could, in our view, limit the extent to which they are able to participate in the balancing market. However, we are also concerned that the impact on the operation of the gas storage market has not been adequately assessed. The approach to date has very much been to acknowledge that it raises issues but the extent of these issues has not been quantified or resolved. We believe that this is a somewhat risky approach given that the flexibility product would have an impact on the future use of storage facilities as a source of flexibility. We are therefore concerned that the impact of the exit reform could have an adverse effect on security of supply and could impact the future use and value of storage in the market.

- **Timetable risks:** It is therefore apparent that the proposed flexibility arrangements would add a significant degree of operational and financial complexity to the already extensive list of reforms that are associated with the DN sales process. In order to implement even a basic framework to enable NTS direct connect shippers and DNs to signal, next summer, their longer-term requirements an extensive amount of work would be required. At the very least, it would be necessary to accurately determine relevant baseline quantities, cost reflective incremental and reserve prices, an over/under recovery mechanism, an overrun regime etc. It would also be necessary to determine an efficient incentive scheme that would apply to the NTS SO. We believe that this would involve the NTS SO price control being amended/reopened to reflect the new product. The NTS SO incentive scheme is already extremely complicated and it would therefore be a significant task to ensure that the proposed incentive is transparent and does not create perverse incentives between the gas energy and capacity regime.

Based on the above, we do not believe that it is appropriate to pursue the proposed commercial and extremely complex flexibility product at this stage. Rather, we believe that a transparent, rule based approach should be taken if potential inadvertent consequences to the wider energy market and a potential delay to the sales process is to be avoided. This would not of course preclude the introduction of a more commercial arrangement at some future date if a rules based approach is proved to be inadequate.

Please do not hesitate to give me a call if you would like to discuss any of the above points in more detail. In the meantime, we have attached to this letter a brief summary of this response, as requested.

Yours sincerely

Rob McDonald
Director of Regulation

Summary of SSE’s response to Ofgem’s Final Impact Assessment on National Grid Transco’s Potential Sale of Gas Distribution Network Businesses

SSE agrees that there is potential for substantial net benefits to customers to be realised by the proposed DN sales by the introduction of comparative regulation. Indeed, the value of comparators in setting price controls was most recently illustrated in the electricity distribution price control final proposals where analysis can show that the removal of the efficiency frontier company would have resulted in an increase in operating cost allowances of some £19m/year across the industry. This would indicate an NPV of comparative regulation for customers of around £275m from the current electricity price control.

In the main, SSE supports the proposed regulatory and commercial arrangements that would support the DN sales process. However, we are very concerned that the proposed NTS flexibility product adds substantial complexity and risk to both the gas and electricity trading arrangements and therefore competition, the impact of which has not been adequately assessed at this stage. We also believe that the complexity of the proposed arrangements could pose a real threat to the completion of the sales process within the allotted timescale. We therefore advocate that a more simple, rules based regulatory approach is adopted to deal with the allocation of NTS flexibility, with more substantive reform to follow at a later date if the perceived concerns materialise.

SSE
14.12.04