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Sonia Brown
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Office of Gas and Electricity Markets
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16th December 2004

Dear Sonia

Re: **National Grid Transco – Potential sale of gas distribution network businesses**

Thank you for the opportunity to comment on the above consultation document. Statoil (UK) Limited (STUK) is an active participant in the development of a divested industry structure through the potential sale of one or more DNs by NGT. As such we would like to further contribute to the development of this process my making the following comments. Please note that our response is not confidential and can therefore be placed on Ofgem's website.

STUK's participation in the development of a regime structure that would support NGT's divestment of some of its distribution networks has centred on enabling this transaction to take place with minimal cost and impact on our customers and also to shippers in general. While many significant changes are a necessary result of a divested industry structure, STUK assert that some are not. In particular STUK has significant concerns regarding the implementation of the flexibility product which will increase complexity considerably, presents a risk to new connections and is therefore a disadvantage to NTS connectees.

As a result of our concerns over this product STUK do not feel that we can provide support for the divestment. It is not clear that, with the flexibility product included, the solution developed by Transco and Ofgem will provide additional benefits or avoid increased costs to end consumers.

Our response has been structured to address the main sections from chapter 5 of the Ofgem document. In addition we have included a section titled “Miscellaneous” which addresses other issues not contained within the Ofgem document.

Allocation of roles and responsibilities

Our response to Ofgem’s consultation document on the ‘allocation of roles and responsibilities between transmission and distribution networks’ stated our preference for the model which was most consistent with the current allocation of roles and responsibilities within NGT. This is shown in figure 5.2 of the Final Impact Assessment document. STUK believe that this model is simple in structure to allow the roles between the NTS and DNs to be clearly defined, enabling each organisation to assume responsibility with all operational and planning functions.

Separation of the functions and responsibilities for the NTS and each DN will enable accountability and transparency of roles. Each organisation will therefore be responsible for its own network and in order for the proposed structure to work, it is fundamental that the offtake arrangements which are designed to govern the operational and commercial relationship between the NTS and each DN are managed effectively.

Under the current arrangements, Transco manage the operations on both the NTS and the eight DNs. Since the beginning of the Network Code, Transco have utilised the necessary tools in which to manage the network safely and have in place the appropriate expertise to manage daily activities on the gas networks. STUK are concerned however that new IDN owners may not (as an organisation), have the core skills in which to run an effective and efficient gas network. This could potentially be damaging to the industry.

Agency and Governance

STUK are generally comfortable with the agency model that had been previously consulted upon by Ofgem. Many of the costs associated with industry fragmentation would be mitigated by the creation of the agency enabling a single interface for shippers to interact with both the NTS and the DNs.

STUK are satisfied with Ofgem’s statement contained within the document highlighting that it would not be appropriate for individual network operators to ‘opt out’ of the agency and would be subject to a five year contractual period and also subject to the approval by the Authority. This would ensure that there is continuity for most of the services which are currently provided to shippers and would also ensure that processes remain aligned through geographical fragmentation. However, STUK would like to stress the importance of ensuring that there is no degradation to the standards of service currently in place for Transco and believe that this could be addressed through an appropriate incentive within Transco’s licence.

With regards to metering, connections and site works, STUK is unclear of how the arrangements will work and is also unsure of who is going to be responsible for the continuity of service in each DN. The majority of shippers/suppliers have an active contract in place with Transco Metering Asset Manager (TMAM) and it is still unclear how the legal rights under these contracts could be transferred over to a multiple number of network operators and also to maintain the current level of service. STUK is concerned that additional costs are likely to be incurred by customers and shippers through the provision of these services, and that these costs are currently unknown to the industry. Implementation of the RGMA project was very time consuming but produced a stable platform in which shippers were able to build systems that were compliant with the RGMA baseline. It now appears that the DN sale will necessitate changes to be made to the RGMA baseline in order to account for multiple transporter entities. STUK believes that the cost to the industry of supporting the required system changes will be significant however Ofgem's document does not provide sufficient information in which to fully quantify the impacts on the industry and we would therefore request that further information and the possible costs associated with such provisions are made available.

It is clear that a new set of governance arrangements will be required if the sale proceeds in order to recognise the establishment of new independent distribution owners. However, NGTs proposal to establish the Joint Office does not appear to have been properly consulted upon and we are therefore unsure of the completed arrangements for this. One of the issues which do not appear to have been resolved is the composition of the panel members. STUK believe that there should be an equal number of voting members for both shippers and distribution networks as this will prevent either party from being able to exercise a dominant position.

STUK agree with Ofgem that the Joint Office should be subject to structural separation from the GT licensees as this will ensure impartiality to the arrangements. STUK welcome the involvement of the Joint Office in co-ordinating a standard approach to the setting of transportation pricing methodologies. STUK believe that the process enacted by the Joint Office to enable co-ordination will be key to ensuring transparency in the consultation process for the DN and NTS Transporter price methodologies.

Offtake Arrangements

The number of changes being proposed to the offtake arrangements is particularly concerning for STUK, notably the flow flexibility product. It is unclear to us why such a complex set of arrangements which will have significant impact on NTS connectees is being developed and at such a rapid pace. Instead of implementing such a complex and untested product it would be simpler to require the DN's to operate under the existing Transco procedures for allocating flexibility to DN's. Transco are under a licence obligation to prevent showing any preference to affiliates and should therefore operate these rules without discrimination. Ofgem could ensure that this does not happen through market surveillance and that IDN owners could raise any discrimination concerns directly to them. The recent decision on GLNG TPA exemption is an example of how this could be structured. The decision taken suggests that a licence condition and a code of conduct should reinforce the relevant separation of GLNG and Transco activities.

STUK are unclear how flexibility can be viewed as being unbundled from exit capacity. The design of the system dictates that investment decisions which create the need for new pipelines to meet higher demands for exit capacity will lead to an increase in flow flexibility capability. Therefore, STUK consider that exit capacity is linked to the inherent system flexibility and must therefore be viewed as a bundled product and that any changes to the quantity of exit capacity will affect the quantity of flexibility available.

It is clear that the benefits to be gained from the introduction of the flow flexibility product are primarily with Transco as this enables them to obtain more control over gas flows within the day. It can be argued therefore that through the implementation of flow flexibility, there appears to be a clear advantage gained by Transco and that the rest of the industry would need to incur additional costs without recognising many benefits.

One of the main concerns which STUK has with these reforms is the lack of pricing information which has made it impossible to realise the true costs associated with them. Without this information, STUK consider that it is extremely difficult to assess the full impact on the industry.

STUK believe that there should be regulatory scrutiny undertaken by Ofgem for the use by Transco of exchange rates to determine the costs associated with trading of exit capacity and flow flexibility. This is to ensure that Transco adopt a non discriminatory approach when setting these exchange rates.

Under the proposals it would appear that the DNs have some advantage over the NTS direct connects in that they are able to decide whether or not they wish to either invest in their own networks or purchase the flow flexibility product on a long term basis. However, the NTS direct connectees are not able to readily make this decision as there is a higher degree of uncertainty for long term decision making which is associated with this class of customers. Therefore, it can be viewed that these arrangements could inhibit competition. It could also be claimed that direct connectees are not in a position to buy long term flexibility. They will have very limited knowledge of the diurnal profile they will require as this will be subject to the markets for which they produce. Under these proposals, this will require them to purchase the product in the short term with a potential exposure to inadequate levels of flexibility and higher costs. STUK do not believe that there will be a secondary market in this flexibility as it is location specific. It is likely that consumers will be required to pay for the overrun charges and therefore be less competitive with other international producers of their products who do not face these costs.

Storage sites in particular appear to be disadvantaged under these proposals. Storage sites provide a source of security and flexibility to the network when it is under constraint and the withdrawal of gas from storage is likely to incur a flexibility overrun charge if the volume offtaken from the NTS is not done under a flat profile. There are also issues regarding the allocation arrangements for multiple user exit points where customer's nominations are held whole but the storage customers have no say in the way the storage operator chooses to flow (or trade) out of any position. It is therefore difficult to identify in aggregate which shipper had generated a charge when storage nominations are not necessarily matched by physical flows.

There are provisions contained within Transco's business rules for flow flexibility which enables them to buy back any previously sold flexibility (anti flow flexibility trade). STUK consider that any actions taken by Transco in which to balance the system must feed into the cash out prices. As yet, no details have been provided in connection with this issue and we believe that this needs to be discussed in more detail.

STUK are concerned over the number of various auctions which could arise through reform of the exit arrangements. There are currently 6 auctions already in place for entry capacity:

- QSEC – quarterly system entry capacity
- AMSEC – annual monthly system entry capacity
- RMSEC – rolling monthly entry capacity
- DSEC – daily firm system entry capacity
- DSEC – daily interruptible entry capacity
- Buy Back Capacity tender process

In addition to this, if implemented, the exit arrangements will create a further 6 auctions:

- Firm Long term release of exit capacity
- Firm Medium term release of exit capacity
- Firm Daily release of exit capacity
- Interruptible daily release of exit capacity
- Long term release of flow flexibility
- Medium term release of flow flexibility
- Daily release of flow flexibility

The addition of the exit capacity and flow flexibility auctions creates a highly complex structure that could create unnecessary volatility in transportation charges through recovery amounts. Our customers on the NTS have indicated to us that it would be difficult for them to determine what their demand levels for gas will be in the medium to long term (unlike DNs) and as a consequence of this, it is questionable why such reform is being undertaken when clearly the benefits are not the same across all NTS connectees.

In order for the sale to proceed, STUK do not consider that major reform to the exit and flexibility arrangements are required and are concerned that Ofgem have attached these projects to the DN sale work. STUK are of the view that this work should be de-coupled from the DN sale work and be progressed through the normal Network Code processes. By doing this, it will afford the industry with sufficient time to develop these proposals and shippers will be able to provide quality responses to proposals that have been developed collectively.

Short term arrangements

STUK believe that the flow flexibility product should not be implemented at all and that by introducing it immediately will increase the costs for all concerned.

There is already a high degree of uncertainty amongst many customers. Fundamental change to the current arrangements will have a negative impact on them and it is therefore important to ensure that during this interim period (2005-2008) no changes should be made to the NTS interruption arrangements. If the Authority decides that Transco is able to sell their DNs, then these customers must be allowed to have some form of transitional arrangements in which to adapt to the new regime.

On the issue concerning Ofgem monitoring all requests for firm NTS exit capacity from current interruptible customers, it is unclear how this will be undertaken by Ofgem to ensure that NGT assesses each request properly. STUK would request further information from Ofgem on how they propose to do this, and on what criteria they will recognise that NGT have not acted reasonably.

Miscellaneous

Ofgem have stated that the base case benefits of £225million have been estimated to be derived from comparative regulation. However, STUK believe that a significant proportion of those benefits could be achieved without the sale of DNs, but through licence amendments aimed at driving greater efficiency, thus providing additional benefits but without the associated cost of implementation and separation.

Ofgem state that there are benefits to be gained through comparative regulation like the introduction of new management. However, we believe that these benefits are more likely to be realised by the IDNs but we are unsure that this will read directly across to RDNs. Although the concept of comparative regulation may enable some transfer of efficiency it is unlikely that they will be able to replicate the achievement of the IDNs as they will be maintaining the same management.

STUK would be interested to know what the likely distribution of benefits will be through the sale of a DN. These benefits are likely to be limited to large industrial consumers that are connected to the NTS as they will undoubtedly have incurred increased costs through revised contracts. There could also be potentially less liquidity in their sector of the retail market leading to a reduction in competition to supply NTS direct connectees. These customers need to be considered as although they are few in numbers, they consume a significant amount of gas.

STUK recognise that there are commercial pressures involved for Transco to conclude the DN sale transactions. However, the timetable through which this process has been conducted has hindered the development process and has prevented some parties from contributing.

Finally, it is very difficult to determine the full costs associated with DN sales as the industry is still developing reform of the offtake arrangements. There are many areas which are still being considered that could have high cost implications. Therefore, it is difficult at this stage to determine the full benefits and costs associated with this in order to complete a final impact assessment. There is also the issue concerning new systems for managing the proposed offtake arrangements, and it is imperative that sufficient training and testing is made available for shippers as the risk of rushed implementation without appropriate testing for new systems could be high.

Conclusions

STUK have provided resource to the development of divested network arrangements in the hope of enabling a commercial transaction to proceed without significantly increasing the costs or risks for shippers, suppliers and consumers. However the current arrangements as outlined in Ofgem's final impact assessment do not represent the minimal change necessary to facilitate the sale.

In particular STUK are concerned that the flexibility product developed by Transco presents significant risks and costs to shippers and NTS direct connectees. STUK believe that Ofgem's concerns about discrimination could be met through other less complex and expensive solutions. As a result of these concerns STUK cannot at present support the sale of National Grid Transco's distribution networks.

To follow is a paragraph summarising STUK's position on the DN sale.

STUK cannot support the sale of the DNs by NGT in its present form. We are very concerned over the complex nature of reform to the exit capacity arrangements and the introduction of the flow flexibility product. The speed of development is very concerning and the need for such complex arrangements is questionable. STUK believe that there is considerable difference between the various NTS offtake points and for this reason they must be regarded as different to each other. The DNs have clearly different requirements to direct connects (customers, storage, Interconnectors) and a blanket approach towards change will not benefit all NTS offtakes in the same way. Therefore STUK have doubts about the effectiveness of the exit capacity reform and believe the flow flexibility product should not be introduced. In principle, STUK do not object to NGT selling a DN, but we do not think that the introduction of the flow flexibility product is in the best interests of our customers and is detrimental to the market

STUK trust that our comments will be given due consideration and should you wish to discuss any aspects of this response further please contact me on the above number.

Yours sincerely,

Robert Cross
Regulatory Affairs Manager

* Please note that as this letter has been sent electronically it has not been possible to sign it.