RWE npower's views on the assumptions and proposals included within Ofgem's final Impact Assessment of DN sales.

Ofgem's final Impact Assessment on DN sales invites views on the key issues, allocation of roles and responsibilities, costs, benefits and risks associated with DN sales. Our response to these points is included below.

<u>Key issues and assessment of the benefits associated with DN sales</u>

We agree with Ofgem assessment that the key issues in respect of DN sales that have potential to create benefits are:
- the introduction of comparative regulation;
- the introduction of independent management teams;
- the potential for improvements in the economic and efficient operation of networks and,
- the potential to promote competition in wholesale and retail markets.

Bearing in mind that 95% of the potential benefits arising from DN sales have been attributed to the introduction of comparative regulation it is imperative that the methodology for estimating these benefits is robust, and based on historical trends experience gained from other regulated industries.

We are supportive of the exogenous approach Ofgem have used in estimating the benefits and accept that Ofgem, as opposed to shippers, are best placed to comment on current thinking and interpretation of best practice in the economic regulation of monopoly industries.

Having taken steps in April 2004 to apply Transco's price control at DN level Ofgem claimed that this would provide them with opportunities for comparative performance, process benchmarking and ratio analysis of DNs, so enabling more effective regulation. It was also assumed that there would be greater management focus which would promote savings that could be shared with consumers. Although Ofgem did not quantify the potential benefits that could arise, and recognised that comparative analysis would be less effective whilst DNs remained under common ownership, it is important that these benefits are taken account of in the no sale option against which DN sales is being compared.

Ofgem appear to have attributed an improvement in controllable opex of 0.5% to DN price control separation and whilst it is difficult for us to judge whether this is accurate or not, any understatement of this efficiency improvement will reduce the benefits attributed to DN sales. Ofgem's base case assumption of a 4.13% average rate of improvement in allowed controllable opex over the next three price controls could be considered challenging, particularly bearing in mind the levels that have been applied in the three previous price controls. However, bearing in mind the bell shaped distribution of benefits assumed by Ofgem, and the fact that the potential for loss of economies of scale does not appear to be significant (as two of the three proposed new owners have existing electricity distribution businesses and in the case of the third proposed owner, any losses in economies of scale should not be allowed to be passed through to customers as its DN business will be compared to each DN in NGTs larger retained DN business), it is not inconceivable that the base case comparative benefits can be achieved.

We do not however, accept the assumptions Ofgem have used in estimating the £17.4m present value of the consequential benefits. We believe there is a significant risk that certain aspects of the proposed arrangements could result in dis-benefits. Whist it might be possible to capture some element of these consequential benefits should aspects of the proposed arrangements be changed (e.g. if capacity and flexibility were to remain bundled), we believe the Ofgem's base case assumption should exclude any consequential benefits, particularly as there has been no sensitivity analysis carried out the benefits which make up the £17.4m.

Key issues and assessment of the costs associated with DN sales

We agree with Ofgem's assessment that the key issues in respect of DN sales that have potential to create costs are:
- the likely level of costs expected to be incurred by shippers and suppliers resulting from the proposals included in Ofgem's four previous RIAs; and
- the likely level of costs incurred by NTS direct connects, Ofgem and the HSE resulting from these same proposals.

We also concur with Ofgem's view that the majority of costs arise from the increased costs faced by shippers and suppliers, and would expect the split between these costs and costs incurred by other parties to be roughly proportional to the 95:5 split assumed for the benefits.

Ofgem's analysis of the costs shippers are likely to incur as a result of the proposals was based on a pro forma questionnaire which was sent to all shippers, and which we replied to. Whilst clear guidance was given as to what costs should and should not be included, it is important to note that the timescales for responding to the questionnaire were very tight (10 days), particularly bearing in mind it coincided with the summer holiday period. Also at the time the questionnaire was issued details of Ofgem's proposals for operational flexibility were not fully understood; the first indication that capacity and flexibility were expected to be unbundled having only been presented at DISG three days prior to the response date for the questionnaire.

With these difficulties in mind, and recognising that it is impossible to obtain accurate estimates of up front development costs and ongoing support without undertaking more comprehensive analysis, shippers views on the costs should be treated with caution.

Whilst it is possible that shippers may have over estimated the costs they will face, we believe it is equally possible that they may have under estimated them, both in terms of upfront and ongoing costs. We accept that shippers are likely to incur roughly common up front costs of implementing the proposed arrangements regardless of their size (particularly with regards to NTS exit capacity and operational flexibility), and believe Ofgem are right to base their base case analysis on a fixed cost method of extrapolation. We therefore accept Ofgem's logic in adopting a clustered approach to shipper estimates, and accept the assumptions they have made regarding non - responding shippers. However, it is not unreasonable to assume that now more details are known about the complexity of the arrangements for operational flexibility, the costs shippers will face could be significantly in excess of the £98m base case present value Ofgem have assumed. For these reasons it we believe a risk margin of +/- 50% should be applied to this base case cost.

Costs have already been incurred as a result of anticipatory changes to invoicing structures. We believe that these changes were not required to accommodate the separation of DN price control, as the old invoice format was fit for this purpose.

There are likely to be other significant costs for suppliers to adapt to changes, which will occur to the non-regulated areas of the industry (e.g. metering) as a consequence of the DN Sales. Although, they may not come within the remit of the IA, they will nevertheless have an impact on the level of benefits passed onto the end customer.

With regard to Ofgem's assumptions about the additional costs incurred by other parties we believe that the costs to NTS direct connects associated with contract negotiation have been significantly understated, at least in the first few years following DN sales. It is not clear whether NTS direct customers were consulted when deriving this estimate. However, as the £2000 costs have been assumed to apply equally throughout the 18 year we do not believe this will make a significant difference to this element of the total costs attributed to other parties.

With regard to Ofgem's upfront and on-going costs, and those of the HSE, we have no reason to challenge the assumptions made. However, we would point out that despite the introduction of market based exit arrangements the regulatory burden of determining whether investment has been efficiently incurred, or whether license obligations have been met or whether an appropriate level of baseline capacity has been made available will only diminish if the market arrangements are a success. Bearing in mind the complexity of the arrangements and the nodal approach that has been proposed, we would also expect there to be a requirement for regulatory scrutiny of the many thousands of nodal exchange rates and the nodal pressure commitments published by Transco NTS. We do not believe that the extent of this requirement has been fully anticipated by Ofgem in their assumptions of ongoing costs.

<u>Options proposed under DN sales following Ofgem's four previous RIA decision documents</u>

RWE npower responded fully to each of Ofgem's previous RIAs on allocation of roles and responsibilities, offtake arrangements, interruption arrangements and agency and governance and we do not intend to repeat all the issues raised previously in our current submission.

However, as Ofgem have welcomed views on these proposals, and as certain decisions have been taken and proposals have been developed subsequent to the RIA conclusions documents, we have included what we still consider to be relevant comments below.

Allocation of roles and responsibilities

Our response to Ofgem's RIA on the above largely supported the conclusions Ofgem reached and the criteria on which we based our support have been largely met. As such we believe that the roles and responsibilities of Transco NTS and the DN businesses are sufficiently clearly defined such that each DN owner will be able to efficiently manage its own network, whilst at the same time co-ordinating and co-operating with other DN owners in matters relating to investment planning, planned maintenance and responses to incidents and emergencies.

We do not believe shippers will incur any material costs arising from Ofgem's conclusions on the allocation of roles and responsibilities.

Offtake arrangements

In our response to Ofgem's RIA on the above we accepted that the DN booking model for NTS exit capacity (Option 2) had merit, although we also indicated that we were not against Transco's initial proposal (Option 1) providing an appropriate dispute resolution mechanism were to be introduced. The description of Option 2 did not specifically refer to NTS exit capacity being allocated to NTS direct connects and DNs by way of auctions, although this was consulted on in the Interruptions RIA. However, Ofgem did clearly state in the Offtake RIA conclusions document that despite the advantages of Option 2 over Option 1 "if the costs of introducing these reforms were prohibitively high relative to the benefits, then it would not be in customers interests to pursue these issues further".

As Ofgem's analysis of the costs and benefits suggests that this is highly likely to be the case, we are surprised that Ofgem now consider it necessary to include provision for NTS exit auctioning within the unified network code.

In choosing Option 2 over Option 1 Ofgem also recognised that it will reduce the possibility that the NTS will be able to exercise any undue discrimination over NTS connectees in the allocation of NTS exit capacity. However, as the extent of this possible undue discrimination has never been quantified in either the Offtake or Interruptions RIAs, it is hard to argue this is a legitimate reason for insisting that provisions for auction arrangements are included in the unified network code from day one.

With regard to diurnal storage and operational flexibility we remain of the view that a market based approach to the allocation of operational flexibility on the NTS network is un-necessary and disproportionate. Whilst Ofgem's analysis in Appendix 5 demonstrates that DNs and each of the different categories of NTS direct connects have different offtake profiles, this does in itself constitute undue discrimination bearing in mind the different operating regimes prevailing at NTS direct connects, and the fact that DNs have access to diurnal storage within their networks. As shippers and DN owners will incur significant costs as a result of the introduction of market based arrangements, and as there was near unanimous opposition to them from shippers, customers and the new DN owners that responded to the consultation, we are disappointed that Ofgem still consider it necessary to pursue this option at this stage. We are also doubtful whether a proper assessment of the impact NTS operational flexibility has on system operation and balancing can be undertaken in isolation, without considering the flow profile of gas at NTS entry points.

Transco stated in their response that they believed a planned approach to operational flexibility was the most appropriate short term model but believed there was merit in developing a commercial approach in the longer term. Despite Transco's apparent change of heart on this issue (which we note occurred around the time that they announced the prospective buyers of four of their DNs) we strongly believe that a planned approach remains appropriate. If the extent of any actual or potential undue discrimination arising from this approach can be quantified, and is found to be material, other less costly and complex options should be considered first (e.g. amended licence condition, code modification or stricter NExA enforcement) before introducing complex market based arrangements.

By insisting that market based arrangements are introduced in the unified network code at hive down, Ofgem are placing an unnecessary and unreasonable burden on shippers and DN owners by requiring them to consider complex issues relating to a market based approach to operational flexibility within very short timescales. This is also being done before the incentives regime and the methodologies for determining baseline capacities and reserve prices are properly understood.

Finally with regard to the issue of business separation we agreed with Ofgem's conclusions in the Offtake RIA that legal separation and targeted structural separation was appropriate. Whilst the retained DNs and NTS have a single ultimate shareholder, we believe their aligned commercial incentives will constrain the extent to which the full benefits of comparative regulation can be achieved.

We were surprised therefore when Ofgem announced that after further consideration of this issue they had decided that full legal separation was not appropriate, and that instead a set of licence conditions could be introduced to mimic the effects of legal separation. We do not consider that the risk of third party contracts referencing Transco's network code having to be adjusted is significant enough in its own right to justify the decision not to require legal separation, and whilst the risk of the wholesale gas market fragmenting into a number of individual network codes is significant, it may have been possible to overcome this by way of further licence conditions.

Notwithstanding the above, we accept Ofgem's re-assurance that they believe it is possible to mimic the effect of legal separation by way of licence conditions such that the comparative benefits resulting from DN sales are fully captured. It is disappointing however, that they don't seem to have the same faith in the adequacy of licence conditions being used to prevent undue discrimination in relation to exit and interruption arrangements.

Interruption arrangements

We are disappointed that Ofgem chose to ignore the view of the majority of respondents, including ourselves, that the status quo (base case) should be maintained for allocating capacity and operational flexibility at both DN and NTS level.

Ofgem's rationale for arguing that auctions, either on a constrained or unconstrained basis, were appropriate was to prevent potential cross subsidies between firm and interruptible users, and to improve investment signals. However, as most interruption takes place on the DN, and as these arrangements are remaining unchanged, at least in the short term, it would seem that Ofgem have changed their rational such that these arrangements now seem to be needed to prevent potential discrimination between IDNs and RDNs, and between NTS direct connects and DNs

Because delays to the discussions to develop the exit proposals that followed Ofgem's decision on the Interruptions RIA, it has not been possible to consider the proposed arrangements in conjunction with the incentives regime that will be in place and the methodology that will be used for setting baseline quantities and reserve prices. It is also not possible at this stage to know how any request for firm NTS capacity over the transitional period will impact baseline capacities at other sites, or the extent to which interruptible capacity will be made available generally or based on unused previously purchased firm capacity.

Agency and governance

In our response to the Agency and governance RIA we supported the establishment of an Agency and the setting up of a governance entity to co-ordinate changes to charging methodologies and a unified network code, as this would mitigate the risk of any material costs to shippers. Whilst we did not argue in favour of option C, and expressed the view that Transco NTS should own and develop the gas nomination, operation and settlement systems (AT Link) and the RGTA entry capacity platform, in light of the Gemini experience we believe that the decision Ofgem have taken is justified. However it is not clear to us whether due to the unnecessarily tight timescales for introducing market based NTS exit arrangements, the system development necessary to support this will be led by NTS SO or by the Agency. Nor is it clear whether the cost of running such systems will qualify as efficiently incurred cost or cost specifically arising as a consequence of DN sales, in future price control assessments.

We also note that Xoserve has not been set up as a “not for profit” company which raises issues for how funding of the Agency and how its cost are treated in future price controls.

Whilst we believe network owners should be responsible for connections to their network and for deciding how they discharge their licence obligations, we still believe that the Agency should have a role in ensuring that the process for requesting a new connection is handled in a standard way. Bearing in mind the history of poor performance in gas connection services we believe that Ofgem should reconsider our proposal for the Agency to have a role in filtering initial connection requests and reporting and monitoring progress on these. In our opinion this is even more relevant now Ofgem propose to introduce GS/OS obligations regarding connections in each transporter licence. It is also an area where we anticipate significant costs will be incurred, and with an Agency involvement we believe these costs could be substantially lessened.

Finally, whilst agreeing that metering should fall outside the scope of the Agency following RGMA go live, we are increasingly concerned that as an indirect consequence of DN sales and Transco’s decision not to install meters (greater than U06) on networks they do not own, suppliers could be exposed to significant costs. This is because although the new DNs MAM would be expected to be RGMA compliant, optionality in the baseline and the introduction of new MAM manuals may result in the supplier receiving data differently depending on the network. There also seems to be a large degree of confusion within Transco as to who will be the Gas Act Owner of their meters which are sited on other parties networks (and indeed their own), and there is a danger that this may result in suppliers becoming the Gas Act Owner by default. If this was the case suppliers would inherit certain statutory obligations they do not currently have and we would very much welcome further clarification from Ofgem on this issue.

<u>Risks arising from DN sales</u>

As highlighted in the impact assessment, if the estimated potential customer benefits are not realised, and/or the actual costs shippers/suppliers incur exceed those that have been estimated, DN sales may result in a reduced net benefit to customers, or worse still disbenefits.

In protecting the interests of customers therefore it is appropriate to use conservative estimates of the costs and benefits, and to fully consider the risks that impact these estimate. As the net benefits Ofgem expect to arise from DN sales accrue over the next three price controls we believe it is also important to monitor the extent to which net benefits have been realised going forward, and to take ongoing action to mitigate the risks over time.

As 95% of the estimated potential benefits of DN sales arises from the assumptions made about the benefits arising from comparative regulation, it is important these are not forgotten when Ofgem come to set future DN price controls. We would therefore expect Ofgem to make a specific reference in each of the next three price controls on how their proposals compare with the base case assumptions contained in this impact assessment, and to fully explain the reasons for any differences.

We are also keen to ensure that any increased costs that NGT or a new DN owner incur as a result of DN sales (e,g, SOMSA costs) must be shown to have been efficiently incurred when setting future price controls, and welcome Ofgem's re-assurances that this will be the case.

Of the remaining consequential benefits that have been estimated to arise from DN sales we believe these should be discounted as there has been no sensitivity analysis carried out on them. It is by no means certain that adopting a market based approach to NTS exit capacity and operational flexibility allocation will improve the desired investment signals or lead to lower investment through improved efficiency. Indeed the opposite may be the case as shippers may avoid bidding for capacity and flexibility in the longer term because of the uncertainty surrounding how much they need and because a secondary market fails to develop, particularly if firm baseline levels are made available day ahead due to the fact that it is only being auctioned in annual strips. It is also possible that disaggregating flexibility from capacity will increase the perceived need for long term flexibility, and it should be noted that Transco have not yet had to make any investment to provide flexibility over and above that that which is consequential to pipeline investment. We had expected that Transco would have published their thoughts on the costs implications of retaining capacity and operational flexibility a s bundled product (as referred to in paragraph 5.73) which may have helped us understand why disaggregation is seen as necessary, but this has not been the case.

Operational flexibility is unlikely to result in a tangible benefit in the electricity balancing market, as has been claimed, as there is no guarantee that flexibility will be allocated to NTS direct connects who value it most. It should also be noted that DN connected power stations will not be subject to the same regime as those connected to the NTS, and so may be able to offer balancing market flexibility on more favourable terms. Based on our current understanding of the business rules being developed for the operational flexibility product, in our opinion it is more likely that a market based arrangement will reduce liquidity in the electricity balancing market due to the complexity of the product and its associated trading/buy back arrangements. We also expect that it will increase the price of balancing market bids, as shippers factor in the costs they have had to pay for the product or the costs of incurring any overrun charges.

With regard to shippers/suppliers costs, there are a number of key areas where action has been taken to mitigate the risk of a material escalation in shippers costs. Whilst recognising that these actions should be sufficient, if they aren't fully effective the very fact that DN sales will have taken place will make it extremely difficult for shippers to avoid such cost increases. If these were included within the net benefit calculation we believe DN sales would result in a net cost to customers, which is why we believe that risk mitigation should be an ongoing process.

For example, as a result of new independent management teams it is possible that IDNs may adopt different methodologies for transportation charging. This could have a material impact on shippers pricing, billing, invoice reconciliation and registration systems. However, this in itself is not the issue as a change in methodology under the current market structure could have a similar effect. The concern shippers have is that changes may also need to be made to systems and processes to allow for the fact that different methodologies apply in different DNs. Whilst Ofgem have given assurances that they will fully consider these impacts, and where appropriate undertake an impact assessments before deciding whether to approve any changes to pricing methodologies, if consent is granted then some of the costs that are likely to arise are costs which the shipper would not have expected to have occurred when DNs were owned solely by NGT.

Similarly whilst action has been taken to prevent DNs withdrawing from the Agency, which should avoid the risk of fragmentation of the core registration and billing systems, if the Agency is unable to effectively discharge transporters obligations because of its governance, funding or the multiple DNs it has to serve, suppliers could be exposed to significant costs as a result of this non performance. This would not necessarily have been the case had DN sales never occurred, and as such the reassurance SPAWG is due to provide to DISG during December on the progress against mitigating actions (as envisaged in paragraph 5.104 of the Impact assessment) is vital.

Ofgem's decision that it was not appropriate initially to adopt market based exit/interruption arrangements within the DN has mitigated against any material costs arising from shippers having to apply the principles being proposed for the NTS at DN level, where the number of customer affected escalates dramatically. However, we are concerned that Ofgem feel it necessary to include a licence obligation requiring DNs to review and develop proposals for the reform of transportation arrangements to interruptible supply points. This could create a momentum for change to be introduced within very short lead times (1 year potentially) and may significantly limit shippers opportunities to influence such changes, which could have a material cost impact on shippers.

Whilst the risk of any retail supply market degradation has been largely mitigated by the creation of the Agency, and their ownership of core registration systems, we believe there remains a risk that supply to NTS direct connects might be adversely affected following DN sales should the market based arrangements be applied to exit capacity. These customers will no longer be able to choose to purchase interruptible capacity, and may find that the number of shippers prepared to supply them reduces because of the complexity associated with acquiring capacity and operation flexibility, particularly if the customer is supplied through a shared supply meter point. Any significant under or over recovery of allowed revenue resulting from the auctions will also increase the volatility of transportation costs, which as these tend to be on a pass through basis for these customers may make it harder for them to budget for their costs.