

Mr Kyran Hanks
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Ofgem
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26th September 2003

Dear Kyran

National Grid Transco – Potential Sale of Network Distribution Business

The Association of Electricity Producers welcomes the opportunity to comment on this consultation document.

The membership of the Association embraces a large proportion of the UK's electricity production and many member companies depend on gas – currently the leading fuel source for power generation. They are, of course, the country's biggest customers of gas.

Ofgem is clearly minded to approve the sale of one or more of NGT's gas distribution network businesses, because '... it should result in net benefits for customers.' The Association is not opposed to such disposals, so long as the arrangements to meet regulatory concerns are established. We are glad to note that the consultation document shows that Ofgem is well aware of the range of regulatory issues that arise. We also recognise the benefits of comparative price regulation in the electricity distribution sector. What is much less obvious from the consultation is how Ofgem has assessed the net benefits to customers. As this is fundamental to Ofgem's decision, the Association would be glad to see more evidence of Ofgem's work on that subject. To that end, we should be pleased to engage in open and transparent discussions with Ofgem and indeed Transco.

Process

The Association is concerned over the number of issues covered in this document and the possible scope of change to the industry, we consider this to be extremely ambitious and in some areas unnecessary. If the full range of issues is to be addressed and the interests of customers are to be safeguarded, then the timetable envisaged looks extremely ambitious. The Association would welcome assurance from Ofgem that the issues can be properly assessed in the few weeks available.

If Ofgem cannot provide such assurance, then we would consider an '*initial views*' document to be more appropriate. This could contain a more detailed regulatory impact assessment and 'minded to' decision, which if positive could be the starting point for development. This will allow Ofgem, the industry and customers more time to understand the issues involved, their interaction and consequences of any proposed changes, including where appropriate development of options.. Ofgem may also like to consider a scenario approach to the regulatory impact assessment; to compare potentially simple, low cost options that may not realise the full theoretical value of the sale of a distribution network to more complex and costly solutions which may potentially realise greater benefits, but also result in ongoing costs. These scenarios and associated regulatory impact assessments should then be subject to review during development as more information enables the likely costs and benefits of the preferred options to be established with more certainty. This iterative approach would lead to a more informed decision as to whether consent for a sale should be granted and also provide the industry with more confidence in the regulatory decision making process.

We also have some reservations over the gateway concept and how Transco would be held accountable for any milestones or objectives that it did not deliver once consent for the sale had been granted.

Regulatory Impact Assessment

The Association recognises that quantifying the costs and benefits of any change is difficult but is disappointed in the lack of detail in the preliminary regulatory impact assessment, which also fails to document and support the underlying assumptions made. We also feel that it is inappropriate for any benefits which may arise from reform of the exit regime or SPA processes to be included as part of the benefits of the sale of a distribution network. These are ongoing projects which should be subject to cost benefit analysis and development in their own right, irrespective of whether consent for a sale is given. It is simply an accident of timing that the reforms may well occur in similar timescales to the sale of a distribution network. In this respect we would like to see debate on reform to the exit regime continue, to build on the debate so far and minimise the risk of development timescales being squeezed at a later stage.

The Association understands that the creation of comparators between distribution businesses might in itself be of value in encouraging innovation and efficiency as well as assisting in setting the allowed revenue at the next price control review. However we feel further analysis should be presented to demonstrate that there is scope for further savings, in addition to those that have already been achieved or can be achieved by separation of the regional distribution price control from April 2004. It is unfortunate that Ofgem's decision document on the separation of the LDZ price control did not quantify the benefits of separation without sale. Ofgem's views on this would be welcome, both in terms of magnitude and so as to avoid double counting of benefits.

It may also be too simplistic to assume that the existence of comparators will lead to cost savings. The number of comparators will also be an issue as will the diverse nature of the regional networks. The Association would expect Ofgem to demonstrate the rationale for assuming that the potential for savings within the gas

distribution networks is similar to that within the electricity distribution networks¹ rather than simply assuming there is scope for a 1.3% annual reduction in controllable costs, as seems to be the case in the draft regulatory impact assessment. The sensitivity of this value to the particular distribution network that is sold would also be a valuable area to explore.

In addition we would welcome further comment on the recent decision on the apportionment of the distribution regulatory asset value between the regional networks that was adjusted to minimise the impact on distribution charges and was therefore out of line with the underlying assets that each regional network has. What will be the consequences of this decision, in terms of the price NGT might achieve for a distribution business and the scope for changing charges to customers more rapidly than Ofgem had previously envisaged?

In summary the Association's view is that, before giving consent to the sale of a distribution business, Ofgem should provide further analysis, which demonstrates that there is a high probability of benefits accruing to customers. Ideally such benefits should be guaranteed via the next price control review. It also follows that there should be a very low to negligible risk of dis-benefits. As proposed at the Ofgem workshop on 10 September, we would welcome the opportunity to comment further on a more detailed regulatory impact assessment in advance of this being presented to the Authority for a go/no-go decision.

The Association provides comments against the specific questions raised in the consultation in an appendix to this document.

Please do not hesitate to contact the Association if you wish to discuss further any of the issues raised in this response.

Yours sincerely

David Porter
Chief Executive
Association of Electricity Producers

¹ Ofgem document – Mergers in the electricity distribution sector – Policy statement May 2002

**ASSOCIATION OF ELECTRICITY PRODUCERS
LETTER TO MR KYRAN HANKS, 26th SEPTEMBER 2003
NATIONAL GRID TRANSCO- POTENTIAL SALE OF NETWORK
DISTRIBUTION BUSINESS**

Appendix 1- Comments on specific questions

Whilst the Association has reservations over the sale of a distribution network at this time, comments are provided against the specific questions raised in the consultation document. We recognise there are tensions between Transco's desire for quick, simple solutions and Ofgem's desire to fully address outstanding issues. In our view the options for development should aim for simple rather than complex solutions in so far as non-discrimination between networks can be guaranteed and customers' interests protected. We feel this approach is most likely to be acceptable to the industry and so ensure that any possible benefits are achieved. This approach would not preclude more complex arrangements in the future if the resulting benefits could be established.

Regulatory Architecture

The Association does not have a strong view as to the extent of separation of transmission and distribution businesses or licensing arrangements that would be most appropriate going forward. We note that Transco is planning to operate the distribution business as separate unit from April 2004. We do however agree that a number of new licence conditions whether within one gas transporter licence or in separate transmission and distribution licences will be necessary, including non-discrimination obligations. Clearly it is important that all networks are operated in an efficient, economical and co-ordinated manner and that the NTS / DN interface is managed efficiently. Non-discrimination between distribution businesses will also be a key objective to ensure customers' interests are maintained into the future.

One approach to finding the most appropriate arrangements might be to develop an understanding of the commercial and operational regimes that would meet the relevant objectives first and then to fit the most appropriate regulatory structure to this. To make decisions about the regulatory architecture first might limit the development of options for the commercial and operational regimes. In this respect a single licence containing the conditions for both transmission and distribution would appear to be consistent with a uniform network code approach.

The Association would not expect the structure of licences to constrain the potential for savings within the distribution networks. We would anticipate that savings would accrue from managerial and operational efficiencies in the achievement of licence conditions. Therefore so long as the licences ensure efficient operation and non-discrimination the exact structure of the licence would not be a major concern. Indeed if distribution businesses were to be subject to different licence conditions then their value as comparators may be diminished.

With respect to governance arrangements, the Association has a strong preference for a uniform network code (UNC) approach. Given experience in the electricity industry with a number of codes with different governance arrangements, we feel the UNC approach would minimise the risk of codes becoming inconsistent and better provide for the consideration of all consequences of any modifications. The Association also considers that the benefits of administrative and commercial simplicity of the UNC approach outweigh the complexity and cost associated with shippers being party to more than one contract for network access and balancing. As such this would best protect customers' interests through maintaining a consistent approach and ensure the benefits of competition in supply are not diminished.

We recognise that this may limit the potential for distribution businesses to develop their own transportation arrangements, but consider that it might be possible to provide for this within a UNC if a scenario were to be developed that demonstrated that such arrangements were to be beneficial.

Offtake Agreement

The Association agrees that if one or more distribution networks are sold then the operational and commercial issues at the NTS / DN interface will need to be addressed explicitly rather than through internal procedures. The offtake agreement proposed by NGT would provide a framework for this. We would also assume that an offtake agreement would be put in place for each distribution network irrespective of whether it has been sold or retained by Transco. This would help to ensure that Transco does not discriminate between retained and independent networks and protect the interests of customers connected to the distribution network.

The Association broadly agrees with NGT's initial scope of the offtake agreement, and consider that an important principle to ensure that customers are not dis-advantaged will be that the NTS and distribution networks should be able to operate as flexibly as they do now. A practical test of the agreements would be to check how they would operate under difficult conditions as experienced this year on the peak demand days in January and 17/18 June when interruption was necessary.

We also have a concern that the offtake agreement will not only be operational but also contain charges for services. As these may ultimately affect the charges paid by customers, we would expect these agreements to be in the public domain and for appropriate governance arrangements to be in place. This may include consultation with the wider industry when changes to the offtake agreement or any charges it contains are proposed. To facilitate this consideration should be given as to whether the offtake agreement forms part of the new multilateral uniform network code.

Exit and Interruptions Regime

The Association has been actively participating in the reform of the exit regime to date and will expect to continue to do so in the coming months. We consider that it is important not to lose sight of the customer perspective in these reforms, such that the sale of a distribution network results in arrangements being put in place,

which would result in customers connected to the distribution networks being at a disadvantage.

The Association would therefore support reforms that allow for customers to contract directly with the system operator that requires the interruption services. In our view direct contracts are most likely to establish the 'value' of interruption, and lead to innovative solutions. However we recognise that customers should not be required to contract directly with the system operator and that many smaller customers would prefer to offer interruption via their shipper. In order to avoid discrimination between customers, we consider that whichever option is preferred should be determined by the customer (and / or its shipper) rather than rules, regarding the type of connection or size of offtake.

Under this approach the role of the offtake agreement, when Transco as NTS operator requires interruption within the distribution networks will be limited to operational rather than commercial factors.

The Association broadly agrees with the objective that Transco (or other system operator) should only contract for interruption that it needs. Ofgem seems to be assuming that Transco currently contracts for more interruption than it needs. The HSE may not agree with this in order for Transco to meet its safety case. Ofgem's real concern appears to be not the quantity of interruption that Transco contracts for but the way in which it pays for it, currently via a fixed fee.

The Association will be pleased to engage in the development of new products structures, that are consistent with the objectives of increasing customer choice, providing investment signals and creating a framework where Transco does not need to pay for interruption it does not require. It would seem that the development of an option / exercise product structure would go some way to addressing Ofgem's concerns. One option might be to allow the exercise price to float such that the real value of interruption on the day would be revealed. Under this approach Transco would then receive investment signals as a function of actual market related prices. However we also recognise that many customers might prefer administrative arrangements and that an approach where both administrative and market based arrangements are available would best meet customers needs.

At this time, the Association's initial view is that there should be a consistent approach to the arrangements for Transco as NTS operator and the distribution network operator for interruption and therefore incentives to manage interruption efficiently. Clearly this will require Transco's exit and interruption incentives to be reviewed and for incentives to be established for the distribution network operators.

Gas Balancing

The Association's view is that the single system operator for balancing is the only sensible way forward. Integrated system operation, of the entire system, with appropriate incentives is mostly likely to result in overall efficient operation, which will minimise the cost. To introduce multiple system operators with shippers being required to balance each distribution network and the NTS separately would introduce unnecessary complexity and cost. A multiple SO

approach would also have a detrimental impact on trading at the NBP and consequential impact on customer prices.

The Association understands that the NTS provides diurnal storage to the distribution networks, the utilisation of which is likely to be greatest at times of highest demand. We also note that at times the NTS can make use of linepack within the distribution networks as it did on 17/18th June this year. Therefore any arrangements to provide these services must be applicable in either direction otherwise the current flexible operation of the system could be compromised. It is also our understanding that use of linepack between the transmission and distribution networks is not a daily occurrence, as flows are generally at 1/24th rate. We note from previous documents that in 1998 Transco only planned to provide the LDZs with 7.5mcm of diurnal storage from the NTS², and that between Oct01 and Sep02 8mcm was the largest within day depletion arising from LDZ demand³. We therefore wonder whether it is appropriate or necessary to establish this as a chargeable service as a prerequisite of the sale of a distribution network, rather than simply include this in the operational agreement with predetermined parameters.

In this context we note that in recent years decisions have been made by Transco to reduce the amount of diurnal storage provided within the distribution networks, as it was more efficient to provide diurnal storage from the NTS. Hence if a charge were to be introduced for the provision of diurnal storage, it would have to be set and controlled in such a way as to ensure that overall efficiency is maintained and investment in diurnal storage within the distribution networks only takes place where this is economically efficient for the whole system and therefore in customers interests.

Other Issues at the NTS / DN Interface

The Association recognises there are many other issues which will need detailed consideration in order for the sale of a distribution network to proceed. We feel that it may be premature to comment on these in detail at this stage. However safety and network planning will be two areas of particular concern to customers to ensure that safety standards are maintained and that system planning continues to take place in a co-ordinated manner to ensure security of supply.

We would also like to note the interactions and dependencies of issues on other decisions. For example, if a single system operator is the preferred approach for gas balancing it may be logical that the management and responsibility for shrinkage and gas quality also lies with the single system operator. We expect the workstreams to fully consider these interactions and iterate initial decisions as necessary.

² Transportation Ten Year Statement 1998, Transco no longer includes this information in its Ten Year Statement.

³ Ofgem document 21/03 The gas trading arrangements, reform of the gas balancing regime Next Steps April 2003