

National Grid Transco - Separation between Transmission and Distribution Networks

A note by NGT for DISG - 24th February 2004

Introduction

In its latest paper on network sales (National Grid Transco – Potential sale of network distribution businesses, Next Steps December 2003) Ofgem states that effective separation between Transco and Retained Distribution Networks (RDNs) is required in order to prevent discrimination against independent Distribution Networks (iDNs).

Background

NGT accepts that unduly discriminatory behaviour by the NTS could adversely impact iDNs and, by extension, the consumers served by those iDNs. Appropriate protections need to be built into the regulatory and commercial framework to protect against such an eventuality. This note sets out NGT's view of the extent of such measures for consideration and discussion.

1. NGT Proposals Regarding Transmission (“NTS”) treatment of DNS

Offtake Code

The risks of discrimination arise at the NTS/DN interface and under NGT's proposals will be managed via the application of the Offtake Code.

Investment and capacity provision process

Commitments arising from earlier planning cycles, or the initial allocation of primary and secondary capacity rights, will form the starting point for the investment planning process.

Demand and associated offtake requirements will be supplied via the DNs as an input to the process.

Whichever model for the commercial/regulatory regime is chosen, NTS will then determine its statutory obligations to provide capacity and will continue to produce a 10 Year Statement consistent with those obligations.

NTS will allocate capacity to the DNs consistent with that statement. The detailed rules for such allocation of offtake rights are set out in the Offtake Code.

It is intended that the provision of primary and secondary offtake rights to the DNs will be published to the industry.

Maintenance

Plans are established in accordance with the process set out in the Offtake Code.

Daily operations

The Offtake Code sets out the rules that will enable DN and NTS to vary offtake flows.

We envisage that the Offtake Code rules will be implemented in a similar manner to the current System Management Principles and Operational Guidelines. We recognise that both DNs and the wider community may be interested in the manner in which the regime operates and so would envisage the continuation of the Operational Forum to provide industry players with the opportunity to enquire about NTS decisions regarding decisions taken on specific days and in relation to specific events on the system. This will allow all parties to build up an understanding of NTS decisions under the Offtake Code.

Furthermore, all of the above processes will be subject to regulatory scrutiny which affords DNs the necessary protection regarding concerns about undue discrimination from the NTS in the operation of the Offtake Code.

Information ringfencing

NGT would propose to impose a Code of Conduct on the communication of information between NTS and all DNs. This Code of Conduct would apply to all NTS employees who operate at the NTS / DN interface and would be reinforced with guidance and briefings.

Separation between NTS and DNs

NTS and Distribution Networks are already separate in many respects, including :

- Separate organisational structures for Transmission and Distribution including separate executives and separate CEOs
- Separate planning tools and processes
- Separate information systems
- Separate employees (other than support services, who do not have access to commercially sensitive information).

Licence Provisions

Existing licence conditions and competition law could be argued to constrain NTS from undue discrimination and to impose the information separation requirements discussed above. However, NGT would expect Ofgem to place licence restrictions on the NTS to support these general requirements.

Given the serious consequences associated with licence breach, this would ensure appropriate observance by NTS.

2. Possible Additional Measures – Legal Separation

Legal separation, whilst providing the appearance of independent structures, does not in itself address the issues raised, since legal separation could be achieved without movement of a single employee.

Although the measures proposed in this note by NGT and the requirement for legal separation need not necessarily be mutually exclusive, legal separation does not actually add any extra protection against undue discrimination.

NGT is also concerned that an increase in the level of legal separation would increase the restrictive covenants required by holders of Transco bonds. This would have the undesirable result of increasing costs associated with Transco's debt book and decreasing Transco's future structural flexibility. Debt costs will eventually impact the cost of capital of the business and both shareholders and consumers have benefited from the flexibility which existing levels of covenants have allowed Transco in the past.

Summary and Conclusion

NGT accepts that Ofgem must ensure appropriate treatment of each DN by the NTS.

NGT believes that the concerns will be adequately addressed by the arrangements proposed – an Offtake Code which provides a transparent set of rules; information ringfencing; continued organisational separation of the NTS and UK Distribution; and, binding licence requirements on the NTS. Under such a regime NTS has little scope for discrimination, strong oversight by the industry, and adequate incentive to ensure appropriate behaviour. In addition, Ofgem would retain the power to require separation, should the measures that have been put in place subsequently prove to be inadequate.

Finally, NGT argues that corporatisation of each DN would not add materially to the protections afforded, may have unforeseen consequences in terms of creating structural rigidity (to the potential detriment of both shareholders and consumers) and would be a disproportionate response, in the first instance, to address potential discrimination.