

Ofgem Consultation on National Grid Transco – Potential Sale of Network Distribution Businesses

Response by Powergen

Regulatory Impact Assessments:

- a) Allocation of roles and responsibilities between transmission and distribution networks**
- b) Agency and governance arrangements**

Overview

Powergen believes that the proposed sale of a number of gas distribution networks (DNs) by National Grid Transco ("Transco") could yield substantial efficiencies both through new management of the divested businesses and comparative competition between newly independent businesses and Transco's retained distribution networks (RDNs).

Nevertheless we remain concerned that many of the proposals put forward by Transco and potential purchasers place too much emphasis on the pursuit of marginal, theoretical benefits, whilst ignoring the additional cost this may place on shippers and suppliers and ultimately customers. Oxera comment in their report into the cost and benefit implications of alternative agency options;

"The detrimental impact on total DN cost savings of a broad agency is outweighed by the high shipper costs and the risk to competition associated with a shift to a narrow agency."

Oxera summary of cost and benefits associated with agency options

	Gamma	Beta	Alpha	Full fragmentation
Shipper costs (£m)	43.02	87.92	98.81	729.52
Risks to supply competition	Low	Low/medium	Low/medium	High
Lost scale economies in provision of shipper services	Low	Low	Low	High
Potential reduction in consumer benefits from DN cost savings (£m)	8.1–12.6	8.1–12.6	8.1–12.6	0

In our view most of the benefits from DN sales can be achieved through better asset management, where there is most scope for improvement. The marginal gains that might be realised through DNOs actively managing system operations within each DN, especially if this in turn leads to DNOs seeking to establish different regional market rules and charging methodologies are probably not worth pursuing.

Powergen presented a "Lessons from BETTA" paper at the Development and Implementation Steering Group (DISG) meeting on 3 February 2004. This paper set out a vision in which benefits could be maximised with minimal impact to shippers and suppliers. It envisaged Transco continuing to fulfil its obligations to shippers through the existing network code arrangements backing-off terms for retained DNs in contractual arrangements (the offtake code). Under this model shippers would not initially have direct contractual arrangements with DNOs although over time contracts for local interruption services might emerge. The paper also suggested national governance arrangements for the network code and charging methodologies and a Central Settlements Agent (initially as an internally separated business within Transco) with responsibility for all settlement activities. It was felt that this structure would provide the best organisational protection against future undesirable fragmentation of processes, systems, market rules and charging arrangements.

We are pleased that in conducting its latest regulatory impact assessments Ofgem has listened carefully to shipper and customer representatives about the potential costs of fragmentation. At this stage however, without clarification of the proposed arrangements for key issues such as the governance and accountability of the agent, it is difficult for us to judge whether the shipper cost mitigation elements of Ofgem's proposals will in fact provide adequate safeguards. Powergen will endeavour to assist Ofgem wherever we can in developing the details of agency governance arrangements.

We believe that if the roles and responsibilities were allocated in accordance with Option 3 purchasers will be able to achieve efficiency gain improvements without marginal efficiency gains being more than offset by increased shipper costs. This is because responsibility for DN system operations would remain with Transco and DNs would see less need to advocate more costly regional market rules and charging structures. In terms of agency and governance arrangements our preference is for Option C as this would ensure all settlement activities and associated systems would be managed by the Agent and administration of changes to the uniform network code and charging arrangements managed by an associated governance entity. **Option 3 and Option C together would offer the maximum safeguards to shippers whilst allowing most of the potential benefits arising from the sale of DNs to be realised.**

a) Allocation of roles and responsibilities between transmission and distribution networks

Our preference for Option 3 is that contrary to Transco assertions, we believe this option best mirrors the organisation of activities and the split of decisions taken centrally or locally within the current Transco business. We favour Transco taking lead responsibility for system operation across the transmission and distribution systems. In reality this represents the only material difference between Option 1 (Transco's preferred approach) and Option 3 (many shippers' preferred approach).

Transco as operator of the transmission system inevitably takes the lead role in ensuring gas flows around the system. Gas is compressed in the National Transmission System (NTS) and is effectively 'pushed' from the NTS into the DNs. DNOs field operations then direct that flow to customers whilst smoothing out diurnal variations in demand through local storage (linepack, bullets and gas holders). It is these physical realities which inevitably dictate that Transco must make key system operation decisions centrally. One only has to look at the constraints Transco plans to place on DNs in the draft Offtake Agreement to illustrate this fact. Option 3 explicitly recognises Transco lead operational role whilst Option 1 fudges it.

Furthermore, from day 1 post DN sales Transco will carry out system operations for DNOs in any case, through System Operation and Managed Service Agreements (SOMSAs), in shorthand Option 1 + SOMSA = Option 3. It is therefore misleading to suggest that there will be any loss of operational synergies or a diminishing of security of supply because a break in responsibilities exists between Transco and the DN under Option 3. Having all responsibilities set out in the one document, the Offtake Agreement rather than two documents, the Offtake agreement and the SOMSA actually improves accountability and clarity.

In terms of ensuring changes are limited to those that are 'expedient and necessary' to facilitate a DN sale, it would be more straight forward if the SOMSA terms were simply included in the Offtake agreement. The greater transparency and accountability to the industry will ultimately ensure fuller regulatory scrutiny compared to a bilateral contract, where there might be more scope for Transco to discriminate between the SOMSA terms it offers to each DNO. This is particularly concerning because it would appear that Transco will use regulatory assets to provide system operation services under the SOMSA.

Cost benefit analysis

For convenience we have chosen to present our views in a similar way to Ofgem. The table below is a revision of table 7.1 to be found in the consultation.

Summary of costs and benefits for each option

Issue	Option 1	Option 2	Option 3	
Accountability and clarity				
• Contractual complexity	✗	✗✗	✓	Less than £0
• Regulatory costs	✓	✗✗	✓	
• Commercial interfaces	✓	✗	✓	
Security of security	✓	✓	✓	
Efficiency savings				
• Comparative regulation	✓	✗✗	✗	Between £3m & £6m
• Economies of scope	✓	✗	✓	
• Economies of scale	-	-	-	
• Operational synergies	✗	✓	✓	
Loss of potential benefit relative to Option 1	£0	Between £31m and £64m	Between £3m & £6m	
Fragmentation avoidance	✗	✓✓	✓✓	

We consider there to be some loss of operational synergies should Transco not continue to take lead responsibility for system operations across the whole network (Option 1). In our view, and contrary to the view expressed in the consultation document, it is also not possible to clearly distinguish between some gas balancing and some constraint management activities and this lends itself to a unified approach to system operations. We do not see how this lack of clarity can possibly be reconciled with the fact that DNOs should will be prevented from not be able to trading gas for energy balancing purposes. Such issues have implications for existing and future system operator incentive arrangements; an area that is already subject to much industry criticism because complexity and of lack of transparency.

We also do not understand how the costs for contractual complexity and regulatory costs for Option 3 can possibly be greater than Option 1. In our view Option 3 is more to cost less. As stated earlier, having effectively a 'standardised' SOMSA as part of a single, fully transparent agreement (i.e. the offtake code under Option 3) must lead to lower contractual complexity. Even in the unlikely event that Option 3 did involve less 'accountability and clarity' compared to Option 1, it would be logical for such costs to be borne by Transco as part of its price control. This is because, in a similar way that the establishment of the agency is an essential prerequisite for the sale, Option 3 also provides some 'structural protection' against shipper costs that might otherwise arise from fragmentation.

It is also difficult for us to assess how valid the loss of benefits associated with comparative regulation might be. To do this one would have to understand which DN costs are truly

controllable and whether DNOs not having responsibility for system operation would preclude them making substantial cost savings. We would suggest that the loss of benefits compared to Option 1 is perhaps no more than £6m.

Ofgem also make a number of observations in relation to security of supply. Ofgem comment;

"The HSE has indicated that it is not clear at this stage how DNs or Transco NTS would be able to demonstrate a safety case submitted under GSMR that the arrangements for co-ordination and co-operation under Option 3 were sufficiently robust to ensure a safe and secure operation of the system, because the nature of the interface arrangements which might operate between DNs and NTS under this model are not sufficiently clearly identified."

The HSE haven't been able to attend DISG meetings at which discussions of the roles and responsibility options have taken place. As such, they may be reliant on discussions with Transco who are hardly likely to have detail discussions about a possible safety cases for options they clearly do not favour. If it were to be made clear the operational similarities between Option 1 and Option 3 and misleading language such as "arrangements for co-ordination and co-operation," suggesting greater complexity avoided, it should be feasible to demonstrate acceptable safety cases for Option 3.

Based on some interesting analysis of international experiences, Ofgem also tentatively suggests that "...a model which assigns responsibility for system operation to the network owner is preferable in terms of security of supply." The data doesn't itself allow a clear cut conclusion. It is worth noting that unlike in the UK the majority of international examples chosen do not involve the transportation of energy within the context of fully competitive supply markets. Any as yet unproven security of supply benefits must in the end be weighed against the added damage that may arise to the UK competitive supply market from greater fragmentation.

In the light of the fragmentation risk associated with Option 1 and, in Powergen's view, the relatively small loss of benefits under Option 3, it would seem most sensible to develop the arrangements on the basis of Option 3.

b) Agency and governance arrangements

Our preference is for Option C, which is most consistent with a vision of the agent managing all shipper settlement activities across the NTS and DNs. Initially the agent could be jointly owned by Transco and DNOs and be regulated in accordance with allowances made for the relevant activities under Transco's existing price control. After the end of the current price control in 2007 the agency could become a fully fledged licenced entity perhaps under different ownership.

A broad based agency role offers the most structural protection against fragmentation of processes, market rules and charging methodologies, whilst allowing each DN to pursue significant efficiency gains by concentrating on asset management activities. We believe that this together with regulatory safeguards to protect against inappropriate industry fragmentation through revised licence conditions and new network code/charging governance arrangements will mitigate the costs that would otherwise be incurred by shippers.

Shippers remain very concerned about the form of any governance arrangements. We note in particular that the RIA is silent on whether multiple network codes with separate modification procedures are envisaged. Similarly, there is little detail on how continued application of national charging methodologies can be assured. Powergen does not support separate modification procedures, as this will provide the mechanism for divergence of market rules which it believes will lead to progressive incremental moves towards 'Full Fragmentation' of trading arrangements. This would essentially be a replication of the costly arrangements shippers already have to deal with in serving customers supplied from Independent Gas Transporter (IGT) networks. **We therefore urge Ofgem to reject Transco's proposal for separate 'short-form' codes with their own separate modification rules.**

Moreover, comparative competition would be impeded as it would be more difficult to compare DNOs under separate or 'short-form' network codes as they would not be equally comparable against the same benchmarks.

The recently published Oxera study illustrates shippers' perceptions of costs associated with different agency and governance scenarios. The scenarios correspond to Option A ('Alpha'), Option B1 ('Beta'), Option F ('Gamma') and No Agent ('Full Fragmentation'). We have used data from the Oxera report and Powergen's views on new variants (Option B2, C, D and E) introduced in the Ofgem RIA to estimated net present values for shipper costs under each scenario.

The Oxera paper clearly illustrates that choice of the scope of the agency and robust, universal national governance should ensure mitigation of shipper costs whilst allowing the DNOs significant opportunity to make the efficiency gains. The trade off of a small reduction in the theoretical scope for DNO efficiency gains is worth the large reduction in the risk of fragmentation. It is achieving the right balance between these conflicting factors that will ultimately ensure realisation of the most benefits for customers.

Cost benefit analysis

Again for convenience we have chosen to present our views in a similar way to Ofgem. The table below is a revision of table 8.1 to be found in the consultation.

The data Powergen provided to Oxera is attached in Appendix 1 which also includes a summary table outlining the estimated costs to Powergen arising from the different agency

scenarios. We would request that you keep this information confidential. This information together with the conclusions of Oxera in their recent report have helped us come to a view on relative merits of the options set out in the RIA.

We agree with Ofgem that the establishment of an agency is an essential requirement to avoid inefficient industry fragmentation. In the unlikely event however, that DN sales were to proceed without the establishment of an agency or there were subsequent moves by DNOs to opt out of the agency arrangements, shippers would face substantial costs. These costs would be driven by multiple interfaces and separate sites and meters databases, leading to poor data quality and a significant degradation in the quality of service provided by shippers to customers. Poorer data quality would undermine the customer transfer process and competition in supply. We have reflected this in a separate shipper customer service line in the table over the page.

In effect, the same problems experienced by shippers serving customers supplied from independent gas transporter (IGT) networks would be replicated but on a much larger scale. Resolving data quality issues and the fall-out in terms of customer queries are highly labour intensive activities. Powergen estimates that it costs at least £25 extra per annum to supply IGT connected customers compared to Transco connected customers.

Option A (Transco's initial proposal), acknowledges the need for an agent but the scope of the agent is largely limited to supply point administration (SPA) systems and some settlement activities. This goes some way to address major concerns about separate registration systems having adverse effects on wholesale and retail competition, but substantial concerns remain with regards to fragmenting settlement systems between Transco/DNs and the agency. The continued dominance of Transco over code governance provides little confidence to shippers that fragmentation and moves towards a 'no agent' world will not arise in a relatively short space of time.

The introduction of an independent governance body to manage the governance of the code modification process and provide secretarial support for charging methodology change processes under Option B1 could be a major step towards avoiding future inappropriate fragmentation of the arrangements. Nevertheless, Option B1 does not deal with the anticipated deterioration of quality of service provided by shippers to customers, associated with fragmenting settlement systems, although it does provide some assurance that problems will not get worse.

Summary of evaluation of cost and benefits options

	No Agent	Option A NGT's initial proposals	Option B1 Introduc- ing govern- ance entity	Option B2 B1 plus credit arrange- ments with agent	Option C AT-link plus RGTA	Option D Splitting systems with responsib -ilities	Option E RGTA with NTS & AT link with Agent	Option F Broadest Agent
Accountability								
• Credit & cash collection	✓	✓	✓	✗	✓	✓	✓	✗
• Settlement & Ops syst	✗✗✗	✗✗	✗✗	✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓
• Connections	✓	✓	✓	✓	✓	✓	✓	✗
Cost mitigation								
• Credit & Cash collection	✓	✓	✓	✓	✓	✓	✓	✓
• Settlement & ops systems	✗✗✗	✗✗	✓	✓	✓✓✓✓	✓✓✓	✓✓✓	✓✓✓✓
• SPA systems	✗✗✗	✓	✓✓✓✓	✓✓✓✓	✓✓✓✓	✓✓✓✓	✓✓✓✓	✓✓✓✓
• DCM governance arrangements	✗✗	✗✗	✓✓	✓✓	✓✓	✓✓	✓✓	✓✓
Non discrimination in modifications process	✗✗	✗✗	✓✓	✓✓	✓✓	✓✓	✓✓	✓✓
Competition								
• Wholesale & retail	✗✗✗✗	✗✗	✗✗	✗	✓	✓	✓	✓
• Metering	✓	✓	✓	✓	✓	✓	✓	✓
• Connections	✓	✓	✓	✓	✓	✓	✓	✗
Quality of service								
• To shippers by NGT/DNs	✗✗	✗	✗	✓	✓✓✓	✓	✓✓	✓✓
• To customers by shippers	✗✗✗✗	✗✗	✗✗	✗	✓✓✓	✓	✓✓	✓
Shipper Cost (NPV)	£730m ¹	£99m ¹	£88m ¹²	£88m ²	£66m ³⁴	£76m ³	£66m ³⁴	£43m ¹

¹ Oxera figures from report, "What are the implications of different agency options for the sale of distribution networks".

² It is difficult to distinguish between likely shipper costs for Options B1 and B2 as these will depend on the robustness of the actual credit regime post DN sales.

³ Estimates based on interpolating Oxera data using Powergen's views of its relative NPVs for options C, D and E.

⁴ Identical costs are shown as fragmentation concerns mostly relate to AT link rather than RGTA, although radical reform to the exit regime could cause RGTA related settlement problems.

Option B2 is similar to B1 except that simpler centrally managed credit arrangements may make it more straightforward for parties to enter or compete more effectively in the market. The shipper credit and cash collection cost mitigation benefits are not significant and could even be beneficial to shippers if new owners establish less rigorous credit arrangements.

Option C in our view represents the optimum position in terms of costs and benefits. Through the agency arrangements and inclusive governance arrangements, it brings shippers closer to the management of all central settlement systems and activities. Accountability for settlement data and data quality that is critical to shippers' balancing and settlement activities will sit with the agent. This in turn will enable Transco/DNs to enhance the quality of service to shippers. At the end of the chain, shippers' quality of service to customers can be enhanced as shippers will have more influence over agency operations compared to those currently carried out within the Transco 'black-box'. Unfortunately, Transco seems to believe that AT-link and RGTA systems, which are important for Transco residual balancing justifies splitting these systems from the other settlement systems it envisages should be operated by the agent.

AT link is a combined NTS/DN settlement system and a secondary 'physical' information tool for Transco. It is an integral part of the suite of UK Link settlement systems currently operated by Transco, and it drives key shipper processes, including energy balancing, scheduling and overrun charges, credit cover and energy allocations (e.g. at interconnectors, connected systems, and shared supply meter points). 'NTS' AT link nominations consist of entry and very large daily metered customer (VLDMC) and interconnector exit nominations. 'DN' AT link nominations consist of around 500 daily metered customers (DMCs), about 2,000 aggregated daily metered customers (DMC) by shipper, by LDZ and about 4,000 IGT nominations.

It is clear from this that AT link deals with transactions both within the NTS and DNs. AT link does indirectly affect physical balancing, but as we know Transco relies more on delivery flow notifications (DFNs) from producers, offtake profile notices (OPNs) from large users and its own view of demands within its DNs to manage this activity. AT link nominations are therefore of secondary importance to Transco. Nevertheless such nominations are of primary importance to shippers as the nomination data processed through AT link drives non-daily meter (NDM) forecasting, which in turn updates shippers real-time balance position. The gas balancing regime depends on financially incentivising shippers to balance their portfolios. In this world Transco is considered to be a residual balancer.

The majority of shippers see significant risks associated with two entities (Transco and the agent) managing different aspects of the settlement process with such critical interdependencies. It is important that we do not jeopardise shippers' primary, or indeed Transco's, residual balancing activities. Our greatest fear is that the non-physical AT-link after-the-day settlement activities will suffer, given that most other settlement activities will be handed over to an agent and Transco will see these few settlement processes it continues to manage as a low priority. In the transition to the Network Code in 1996, shipper energy

allocations caused huge problems for Transco. The data errors cause disputes with shippers involving millions of pounds. We do not see such a reoccurrence of such problems.

RGTA is essentially a capacity trading platform with outputs into other settlement systems. Possible radical changes to the exit regime could however create critical interdependencies with the agent's settlement systems and particular DN processes. It would seem better for the RGTA trading and settlement system therefore to be managed by the agent.

Overall AT link (and possible future RGTA) processes straddle the NTS/DN interface, so operations are best vested in a 'neutral' agent. Transco dominance of these crucial systems would seem to be undesirable. An integrated (i.e. a single agency home for all settlement systems) provides the greatest assurance that data quality and hence balancing and settlement performance will be maintained or improved. In addition, subsequent new ownership of the agent is facilitated if all settlement processes are kept in one place as it represents a more coherent business proposition for a potential buyer.

We do not consider Option D to be a realistic option for day 1 post DN sales. It seeks to separate the responsibility for 'physical' operational data from 'paper' settlement data, more akin to the electricity industry. In the gas context such a clear distinction is difficult. It would require the design of new systems and depend on contractualisation of 'physical' DFNs and real time shipper allocations across and between the networks. It would however align accountabilities for physical residual balancing with the direct ownership and control of the relevant systems, but at what cost?

Option E provides most of the safeguards and benefits associated with Option C, with the exception that Transco keeps sole control of the RGTA system. This represents a departure from the vision that the agent should be responsible for all settlement activities, processes and systems currently managed by Transco. Ignoring future RGTA developments that straddle the NTS and DN activities it does however, provide the majority of safeguards many shippers are looking for under Option C.

Option F as closest to the status quo is the best option for shippers in terms of shipper cost mitigation. However, from an overall cost benefit perspective it has a number of minor deficiencies in that it might undermine to some degree competition in metering and be less beneficial in terms of credit and cash collection accountability.