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Date: 17 May 2004

Dear Sonia

National Grid Transco – Potential Sale of Network Distribution Businesses. Agency and Governance Arrangements RIA.

We welcome the publication of the above RIA and the opportunity to respond to the options that have been tabled in respect of the scope of the proposed Agency and future governance arrangements.

Overriding principle

In considering which functions should be assigned to the agency it is essential to consider the merits of centralisation against the alignment of accountability and delivery. We firmly believe that, as far as possible, the responsibility for carrying out a function should be aligned with the obligation to do so. Clearly, each incidence of mis-alignment not only introduces an element of risk to the party that has the obligation but it also significantly clouds the liability path in the event of sub-standard performance and/or failure.

SSE's approach

Ideally, therefore, we believe that there is merit in considering a model whereby NGT would *retain the obligation* to provide specific “critical” functions for the market as a whole and would do so by providing a regulated service in much the same way as it does currently. For example, under this model the obligation to provide the SPA function, settlement and some of the other functions currently being considered for inclusion within the agency would be retained and fulfilled by NGT.

In particular, NGT would have the obligation to provide the main SPA and settlement service, however the DNs would have direct responsibility for billing and credit control which, in the interim would be provided by NGT according to a separate commercial

agreement. However, given the importance of this function to a DN's financibility we consider that the interim provision of these services by NGT would need to be regulated.

How NGT organised itself internally to deliver this would be a matter for NGT. The key benefits of this approach would be to maintain direct alignment of the obligation for key specific functions with the body tasked to carry it out. Two further advantages of this approach would be that it would minimise the risk of future fragmentation for shippers/suppliers. It would also minimise the risk of discrimination since NGT would retain the obligation to provide the services equally to **all** networks and, therefore, it would not be in its interest to do otherwise.

In other words, we believe that an approach whereby NGT retained the obligation to provide regulated centralised SPA and settlement services would resolve the key issues that are associated with establishing the agency and that Ofgem has identified in chapter 4. That is, cost mitigation, effect on competition, accountability, funding and quality of service. The remaining issue would be governance. If NGT were to own the obligation to provide these services to all Distribution Networks (DNs) (ie retained and independently owned DNs), issues in respect of discrimination, agency ownership and subsequent control would not arise. Therefore, the only governance issue that would have to be addressed would be to ensure that the Universal Network Code (UNC) modification rules allow for appropriate representation by stakeholders with a legitimate interest in the areas of the code against which a change had been proposed.

Given the above, we believe that Ofgem should re-consider an approach whereby NGT would retain the obligation to provide these "critical" DN functions centrally. We believe that this approach would be far preferable to adopting a model whereby the common obligations lie with the separate DN owners who subsequently contract with the agency for their delivery.

The proposed agency models

Nevertheless, Ofgem's RIA is based upon an approach that assigns common obligations to each DN. If this approach is to be adopted, we support the concept of creating an agency to provide, on a centralised basis, some of the services associated with these DN obligations and which are currently provided by NGT. The aim being to minimise the costs associated with moving to a more fragmented industry structure following the sale of one or more DNs.

In assessing which activities should be carried out by the agency we believe that a basic principle should be applied whereby only those activities that are jointly dependent upon the use of the *same* system by different network owners should sit within the agency. That is, NTS-only activities and associated NTS-systems should sit with NGT and DN-only activities where individual DNs *each* have the system/capability to perform the function itself should sit within the DN. Activities that are either common to NTS and DNs or common to all DNs but which rely on shared systems should sit with the agency.

Having considered the various options that have been presented within the RIA, we agree with Ofgem that either option B1 or option E appear to be the most appropriate. The common features of these options that we support over and above the other options is that the DN would manage its own credit and cash collection, the creation of a governance entity and the retention of RGTA activities and systems by NGT.

The distinction between options B1 and E is where the “control” of AT-Link is placed. We understand that all parties (ie NGT, DNs, the agency and shippers) require access to/interaction with information that is provided to/from AT Link. On balance, therefore, in view of the basic principle set out above whereby systems that are required by more than one party should be placed in the agency, we conclude that control of the AT Link system may be better placed within the agency, ie option E. In the event that this option has a cost implication due to NGT’s amalgamation of its RGTA and AT Link system in its development of Gemini, this cost should be borne by NGT.

Notwithstanding the above conclusion, we do have some other concerns with the allocation of some of the activities within options E and B1.

- (i) We observe from Ofgem’s figure 7 that the allocation of the AT Link system to the agency, would mean that NGT would need to create an additional system/activity “Transco operational systems”. We do not understand what is meant by this but assume that it has something to do with NGT receiving information from the AT Link system. We therefore question whether there should be a similar requirement in respect of DNs so that they too gain equivalent access rights to information provided by/to AT Link as NGT. More generally, we believe that considerably more information and clarity is required on an independently owned DN’s (iDN’s) access to information from shippers, NGT in its role of NTS SO and from the agency.
- (ii) We note that all options other than option A place the demand estimation function within the agency. We do not believe that sufficient consideration has been given to the implication of placing this activity either within the agency or within NGT and therefore, it is not clear where best to place this function on the limited information that is available. We would therefore ask Ofgem for further clarity on this issue and to share with us NGT’s view as to why it is best retained by NGT under option A.
- (iii) We do not agree that the iDNs should have a metering responsibility. NGT have explained that the metering assets associated with the DNs it has offered for sale are not included as part of the sales process. Therefore we believe that it would be wholly unacceptable for iDNs to be given a metering obligation that is associated with regulated assets that it does not own. Otherwise, regulatory control of metering would be undermined and iDNs would be exposed to NGT’s apparent market power in the provision of metering. Therefore, the “metering obligation of last resort” should be retained by NGT to be fulfilled directly by its regulated metering business or by contract with a third party.

- (iv) We believe that greater consideration needs to be given to the list of activities associated with “other Network Code obligations” and whether individually they sit comfortably within the agency or whether it is more appropriate for them to be carried out by the relevant network owner. For example, we are unsure what is meant by “NeXA supply meter points” in the context of an agency function since this is an agreement between a DN owner and a specific offtake point. Similarly, we are unsure what is meant by “the management of user admission and termination”. If it means the control of who is a user of the individual DNs we believe that this is directly related to credit arrangements etc and should therefore be managed by the DN itself. In other words, we believe that more detail is required on what is envisaged under this activity box.
- (v) We do have an element of concern that the DNs would be dependent upon the performance of the agency for securing their revenue since the agency would carry out the transportation billing function. We therefore believe that in future, DNs may prefer to perform this themselves, using settlement data derived from the agency. In the meantime, given the importance of this function to a DN’s financiability it should be a regulated service.

Other issues

1. The governance entity and governance of the UNC.

As we have noted above, we support Ofgem’s proposal to introduce a governance entity. We believe that this would help address potential concerns surrounding NGT’s ability to discriminate in the Network Code modification process post DN sale. In our view, the governance entity should be jointly owned and funded by NGT’s NTS, NGT’s retained DNs (rDNs) and iDNs. However, in order to achieve this, it will be necessary to ensure that the relevant provisions for this funding have been provided for within the separate DN price controls and have not been allowed for solely within the NTS price control.

We do not believe that it would be necessary for this body to be independently owned at the following price control review. We believe that any concerns in respect of the influence network owners may have over the governance of the UNC could be adequately addressed by the UNC modification rules themselves. That is, the rules can be defined to ensure that adequate representation and influence is afforded to all parties with a relevant interest in the area of code that is under consideration. In securing effective governance of the industry codes Ofgem should also address NGT’s current ability to dictate the detailed implementation of Ofgem’s approved modifications, including the detailed system specification and implementation timetable.

2. Funding and Ownership of the Agency

We understand that post sale the agency (including the systems that support the activities it undertakes) will be jointly owned by NGT and UNC gas transporters by virtue of the proposed xoserve Shareholder Agreement. We also understand that the agency will be jointly funded from the revenue allowances provided by the current NTS and DN price

controls. Nevertheless, it would appear that NGT would be the dominant party in this arrangement and therefore, in the immediate term NGT would have ultimate “control” over the agency.

3. Regulation of the Agency

Given NGT’s dominance within the proposed agency, we believe that a situation may arise, for example, whereby NGT could seek to increase DN agency charges over and above those that have been “allowed” within the DN price controls. We therefore believe that given the agency’s market power in the provision of these services, the amounts charged by the agency to DNs and NTS should be directly regulated by Ofgem at least until the 2008 price control review. Furthermore, it is evident that in the event that NGT decided to withdraw its participation from the agency and find alternative means of providing these services itself, the iDNs would be placed in an untenable situation of having to fund the agency services and supporting IT systems. For this reason, we believe that there should also be a requirement on NGT to be a party to the agency.

Given the above, we agree with Ofgem that in the shorter term it would be appropriate to ensure that the agency is effectively regulated in terms of provision of service and the control of agency costs ie charges to NGTSO and the DNs.

Conclusion

To summarise, we believe that the simplest and most cost effective solution to providing the core services that are being considered within the agency proposal would be for NGT to retain the regulatory obligation to provide these services as part of its regulated business, funded through its NTS price control. Under this approach, the key issue that would need to be addressed would be the governance arrangements of the proposed UNC, both in terms of control of the governance function and the rules associated with making changes to the code (and the subsequent process for implementation of approved modifications).

However, rather than pursuing the above approach Ofgem has proposed a number of alternative agency models whereby the obligations for these functions would lie with each DN owner to be carried out by a central agency function. Of the options tabled within the RIA, we believe that option E is the most appropriate, but, failing that we would also support option B1. However, whichever option is ultimately adopted it is important to ensure that NGT does not dominate either the proposed governance entity or the ownership of the agency. Therefore, in order to avoid NGT gaining disproportionate influence or inappropriate commercial gain from the agency proposal we believe that it should be regulated in the short term at least. Furthermore, we believe that some form of protection is required for iDNs to mitigate the risk of NGT’s rDNs withdrawing from the agency or failing to co-operate should an iDN decide to procure certain agency services from elsewhere.

We hope that you will find the above comments useful. Please give me a call if you would like to discuss any of the points we have raised in more detail.

Yours sincerely

Rob McDonald
Director of Regulation