DN Sales Development & Implementation Steering Group Minutes

Meeting 10

18 May 2004, 10:00 am – 2:00 pm

Ofgem's office, 9 Millbank

Attendees

David Ashbourne	Ofgem	Simon Goldring	British Gas Trading
Farook Khan	Ofgem	Martin Kinoulty	United Utilities
Sonia Brown	Ofgem (chair)	Paul Whittaker	National Grid Transco
Jess Hunt	Ofgem	Mike Ashworth	National Grid Transco
Jason Mann	PA Consulting	Nigel Sisman	National Grid Transco
Tory Hunter	Scottish & Southern Energy	Chris Train	National Grid Transco
Eddie Proffitt	MEUC	Sue Higgins	National Grid Transco
Keith Harris	Wessex Water	Mark Sutton	National Grid Transco
Peter Bolitho	Powergen	Peter Bingham	National Grid Transco
Charles Ruffell	RWE Innogy	Nick Wye	Waters Wye Associates
Nigel Nash	Ofgem	Sebastian Eyre	energywatch

1. Review of items from previous DISG meeting held 4 May 2004

a) Review of minutes

There were no comments on the minutes.

b) Review of actions

The actions arising at the previous meeting had been discharged as follows:

ACTION: *Shippers to respond to Transco's paper on UNC governance at DISG 10.* Peter Bolitho had prepared a paper that was circulated to the group on Friday 14 May.

ACTION: *Transco to provide (to DISG 10) further information regarding the operational information flows received by DNs, including:*

- *What information is currently received by DNs? In particular, what information is received via the ACCs?*
- *What are the timescales associated with this information?*
- *How will these information flows change going forward?*
- *What information does the DN currently provide to the NTS?*

Transco had prepared a paper which was to be discussed later in the meeting.

ACTION: *Transco to report on how to resolve the issue of credit risk on IDNs at DISG 10.* This action was due to be discharged during the meeting.

ACTION: *Ofgem to rebase Figure 9 in the Agency & Governance RIA against Option A. Due DISG 10.* Ofgem had circulated a rebased chart to the group 17 May.

ACTION: *Group to consider Transco's paper and presentation on the governance of the agency at DISG 10. Group members to raise any issues with Transco prior to the meeting.* This action was due to be discharged during the meeting.

ACTION: *Ofgem to present options for allocating offtake rights to the CIWG and then report back at DISG 10 with CIWG members' views for guidance and/or directions.* This action was due to be discharged during the meeting.

3. Report from the Commercial Interfaces workgroup on options for the offtake arrangements

Sonia Brown said that the previous CIWG meeting had discussed an Ofgem presentation on different options for the offtake arrangements, and that Jason Mann would give a presentation which updates the DISG on the discussion of the CIWG. Jason Mann gave a presentation outlining four options for the booking of NTS exit capacity rights:

- Transco proposal
- DN booking model
- Combination DN-shipper booking model
- Shipper booking model

Jason noted that the combination model was a new model that has not been considered by the CIWG.

Transco proposal

The group discussed what should happen if the NTS and DN disagree on the MDQ required to meet network operators' 1 in 20 licence obligation under the Transco model. Mike Ashworth confirmed that under Transco's proposals, the NTS would make the final decision on the level of MDQs to be provided, however there would be scope for the DN to appeal to the regulator if it was dissatisfied with its MDQ allocation.

Peter Bingham said that in the electricity industry, National Grid determines the equivalent of MDQs for distribution networks, and this approach has not proved problematic. Sonia Brown said that due to the characteristics of gas, DNs in the gas industry have a much more active role in managing the network.

Nigel Sisman suggested that there was limited potential for substitution between NTS and DN capacity investment, because the networks needed to be able to carry MDQ across both sides of the connection point. He considered that the key area where there is potential for issues to arise is storage capacity.

Chris Train suggested that growth rates within the networks are relatively stable, and consequently it is unlikely that big investment requirements will arise within current planning horizons.

Sonia Brown said that it was important to design a set of arrangements that are robust to different commercial incentives going forward.

Keith Harris said that the key objective of the offtake arrangements should be to create a set of arrangements that are capable of demonstrating to the regulator that investment expenditure is efficient and economic. He suggested that this objective was likely give rise to a more interventionist role for the regulator.

Chris Train agreed that the Transco model created pressure for Ofgem to have an active role in resolving disputes between the NTS and the DNs over MDQs. He said that it was not clear how acute this pressure would be going forward. He considered that the correct approach is to look at each aspect of the various models for allocating MDQs, each of which have different strengths, and to find the correct balance of tensions.

DN booking model

Jason Mann explained that under the DN booking model, shippers would book capacity on the DNs in the same way as at present, and the DN would book NTS exit capacity rights. He said that it may be necessary for NTS direct connects to contract for 3 years ahead, and that there could also be potential for shippers to request longer exit capacity rights on the DNs. Under this approach, the DN would face an incentive to book an efficient level of NTS capacity. This incentive could take the form of the DN paying a fixed proportion of NTS capacity charges. Jason said that the level of NTS capacity bookings would drive the level of charges faced by shippers.

Some group members suggested that an incentive scheme would encourage DNs to under-invest in their networks. Sonia Brown said that the purpose of the incentive is to ensure that DNs' obligations are delivered in an economic and efficient manner, however, the overall level of investment is determined by the 1 in 20 standard.

Paul Whittaker noted that the inducement to under-invest associated with the incentive scheme would be negligible compared to the overriding incentive of the price control. Chris Train added that an annual incentive does not have a major impact on decisions relating to long life assets.

The group discussed the effect of the incentive scheme on DNs' risk-taking behaviour. Keith Harris suggested that more highly geared companies will be more sensitive to investment incentives than less highly geared companies. Tory Hunter held the view that the incentive scheme would result in risk being placed on the DNs that was not consistent with the rate of return. Sonia Brown suggested that the DNs would be subject to a level of risk that is commensurate with their rate of return. Keith Harris agreed that the scope, form and duration of the incentive scheme were the determinate factors.

The group discussed where payments for NTS capacity would flow under the DN booking model. Sonia Brown said that there were two variants for cash flows:

- under the first approach, the NTS would receive payments directly from shippers
- under the second approach, shippers would pay DNs and DNs would pay the NTS.

Nick Wye suggested that DNs could have a cash flow issue if NECs are booked three years in advance but shippers are only required to make annual payments.

Tory Hunter noted that under the second approach the DNs would be responsible for recovering NTS charges.

Chris Train said that the choice between variants A & B was partially dependent on the outcome of the exit debate. Sonia Brown agreed that different relationships could affect contractual arrangements for interruption.

Jason Mann said that shippers' liability for NECs would be calculated as a function of their SOQ, however, the DN would determine the overall level of NECs in accordance with its 1 in 20 obligation.

Nick Wye suggested that since the NECs and sum of the SOQs were likely to be different numbers, there would be a misalignment of the DN's NTS capacity booking incentive. Paul Whittaker said that this would not occur, as the NTS capacity booking incentive is directed at investment decisions, whereas pricing decisions are largely paper transactions where the DN pricing methodology determines each shippers' share of total NTS revenue.

Eddie Proffit suggested that if one DN underbooked NTS capacity, this would have a flow on effect on the customers of other DNs because the NTS would adjust its charges so that it still recovers it allowed revenue. Sonia Brown said that the incentive scheme would include upper and lower boundaries that limit any adverse outcomes that might arise.

Combination DN-shipper booking model

Jason Mann said that under the combination model, shippers would be required to book NTS exit capacity three years in advance. Simon Goldring questioned whether shippers would have access to sufficient information to be able to estimate their requirements three years in advance. Sonia Brown said that the objective of this proposal was to raise a question as to whether market participants are better at estimating future requirements than a monopolist.

Simon Goldring noted that under the combination model, shippers would be required to pay for the additional NECs booked by DNs in order to meet their 1 in 20 obligations, even if shippers do not overrun the level that they have booked themselves. Jason Mann noted that this outcome was an inevitable effect of the 1 in 20 investment planning obligation.

Shipper booking model

Simon Goldring suggested that if shippers were responsible for booking NTS exit capacity, there may be a tendency to under-book, because the market will be driven towards the lowest common denominator. He asked what would happen if there was insufficient gas on the 1 in 20 day – in particular, how would gas be allocated and how would the cost associated with the shortfall be recovered?

Sonia Brown said that the different options for NTS exit capacity booking would be assessed by group members at the next CIWG meeting, and that afterwards Ofgem would address the issues in its RIA on the offtake arrangements. Sonia said that if DISG members wished to discuss further the NTS exit capacity booking arrangements, they could attend the CIWG meeting on 26 May.

4. Shipper's response to Transco's UNC governance proposal

Peter Bolitho described the key issues set out in his paper on Transco's UNC governance proposal.

Independence of the governance entity

Sebastian Eyre said that the independence of the governance entity needs to be related to an end objective which seeks to reconcile the various commercial interests of industry participants.

ACTION: Sebastian Eyre to provide views on the objectives that should apply to the governance entity by Friday 28 May.

Peter Bolitho agreed that the key issue is the independence of the governance entity. He said that a key aspect of independence is how it is achieved, for instance, whether the governance entity is a ring fenced Transco body, or an Elexon-style body, or linked to the agent's role. Peter noted that some shippers favour the current arrangements because it is clear where Transco is partisan, whereas an independent governance entity might have its own agenda. These shippers would like the gas transporters to control the governance entity, and potentially they would like a single gas transporter to control the governance entity because one party would be easier to deal with than multiple parties.

Chris Train said that Transco was aiming for an incremental improvement in UNC governance processes. He said that accountability is required, and that it is appropriate that gas transporters are the accountable parties. He noted, however, that there is a need to open parts of current UNC governance process to create a more diverse representation of views and to increase the role of the modifications panel. Chris said that Transco's concerns with the introduction of an independent governance entity were

- ♦ it would make it difficult for gas transporters to demonstrate compliance with their licence condition regarding the UNC modifications procedure; and
- ♦ there is a risk that industry could lose control of an independent body.

Sonia Brown asked the group whether they thought that gas transporters should be accountable for delivering an arm's length governance entity, or whether other parties should also be able to participate. She asked group members to assume that the costs of the governance entity would be controlled under either model.

Peter Bolitho said that the arrangements would be closer to a level playing field if shippers could run their own modification proposals. He said that independently chaired meetings and reports were key to securing an independent governance process.

Chris Train suggested that it was advantageous to permit the flexible resourcing of a gas transporter-run governance entity rather than full ring fencing because the governance entity's workload is likely to fluctuate. Sonia Brown said that this issue could be addressed even in the presence of ring fencing, for instance through the use of secondments.

Eddie Proffitt said from his perspective, the current modifications process appears to be dominated by Transco. He said that if a DN sale occurred, the balance of power within the industry would change because a new key class of stakeholder would be created.

Eddie's view was that since Transco would retain dominance over a governance entity controlled by gas transporters, it was necessary to go a step further and establish a fully independent (but cost controlled) process.

The group considered how much the governance entity was likely to cost. Chris Train indicated that the administrative and legal costs would be moderate, however it was not clear how modification proposals would be managed in the absence of the experts who are currently embedded within Transco's business. Simon Goldring said that a truly independent body could struggle to deliver satisfactory outcomes unless access to expertise is built into the modifications process.

Role of the modifications panel

Peter Bolitho said that it is important to ensure that the UNC governance procedure prevents single entity or group from dominating the modifications process and that an key aspect of this is to allow the modifications panel to make the recommendation to Ofgem on whether to accept or reject a modification proposal. Chris Train agreed that this was appropriate.

Peter Bolitho said that the broad principles for makeup of the panel should be that the panel represents a broad diversity of views and is not remote from industry. Peter considered that the current makeup of the panel to be relatively efficient, however, he suggested that it might be appropriate to consider whether the addition of independent panel members would be likely to add value.

Sonia Brown asked whether other members of the group considered the current modification panel to be appropriately constituted.

Eddie Proffitt thought that the current balance strongly favours shippers over suppliers, and that customers are under-represented. Sebastian Eyre thought that the consultation and planning process adopted by Elexon worked quite well. He thought that the constitution of the panels should to be able to evolve with industry. Peter Bolitho questioned the extent to which customers would be interested in participating in modifications panel processes in practice.

Peter Bolitho favoured an approach which establishes a single process and a single recommendation, with scope for a modification proposal to go to the workstream for development if necessary. Simon Goldring suggested that customers could potentially have a role in the workstreams and the panel could have a procedural function.

Chris Train said that the modifications panel should determine the timelines associated with modification proposals because there is a danger that the detail of difficult issues could be overlooked if inflexible deadlines are adopted.

Peter Bolitho suggested that there was also potential to grant an industry panel some limited decision making powers, rather than referring all decisions to Ofgem. This type of arrangements was contemplated under the SPAA. Simon Goldring noted that whilst the SPAA allows the panel to have a role in the application of rules, this role does not extend to the development of rules. Peter acknowledged that it was often a difficult line to draw.

Sonia Brown requested examples of the types of decisions that Peter was talking about. Nigel Nash suggested that the electricity MRA provided an example of a system which incorporates decision-making powers by industry forums. Sonia Brown noted that there were a lot of appeals under this process.

Peter Bolitho suggested that if the Authority fails to make a decision on a modification proposal within a given time period, then the panel's recommendation should stand. Sonia Brown suggested that if this approach was adopted, then there should also be a mechanism that enables the Authority to send back proposals that haven't been properly assessed.

IT decision making process

Peter Bolitho said that at present, Transco controls the IT decision making process and that in future, shippers should be able to instigate changes. He considered that it was appropriate for shippers to have a greater role in the IT decision making process than merely having the right to participate in a consultation process. Chris Train agreed, saying that this was consistent with Transco's proposals for the agency.

Charging methodology

Peter Bolitho described the options for the governance of gas transporters' charging methodologies set out in his paper. He said the objective of each option was to find a mechanism that prevents unilateral changes to a gas transporters charging methodology without the change being considered on a national basis.

Sonia Brown said that Ofgem's Agency & Governance RIA contemplates that the governance entity would be responsible for administering charging methodology modification proposals in accordance with a national process. She noted that if one DN implemented a successful change, then other DNs would be under pressure to also adopt the change. Peter Bolitho said that shippers would want the implementation of changes to be coordinated, rather than having to roll out a given change on a piecemeal basis as each DN adopts it.

Paul Whittaker noted that there were three different types of changes to the charging methodology that required coordination:

- price changes that are intended to ensure that a network operator recovers in accordance with its allowed revenue;
- price changes which reflect a reallocation of internal costs to charge types; and
- the introduction or removal of types of charges.

Paul said that the introduction or removal of types of charges is the key issue because it has the biggest implications for shippers' systems.

Eddie Proffitt expressed a preference for a single uniform charging methodology that is applied across all DNs. In addition, he thought that the timing of price changes should be coordinated across all network operators. Jess Hunt noted that there are mechanisms for ensuring that timing is coordinated without introducing a uniform charging methodology.

ACTION: Transco to develop a more detailed UNC governance model that addresses the issues raised in Peter Bolitho's paper.

5. Governance of the agency

Chris Train said that the role of the agency to deliver gas transporters' licence and UNC obligations in accordance with an agency services agreement. In response to a question from Jess Hunt, Chris Train confirmed that other services which are not currently included in Transco's licence and UNC obligations would also be covered by the agency services agreement.

Chris Train said that Transco is currently drafting a 5 year services contract to apply to xoserve which reflects existing service standards. Potential DN purchasers will have the opportunity to see the contract in the data room. Sonia Brown asked why the arrangement was being entered into for 5 years given that the funding of the agent was not determined beyond the next price control review. Chris Train said that Transco appreciated that factors may evolve and the contract was being drafted accordingly.

Chris Train said that in addition to the agency service agreement, Transco also intended to prepare an agency shareholder agreement, which would establish the framework for the relationship between the agency's shareholders. Parties to the agency shareholder agreement would be xoserve and UNC gas transporters.

Under Transco's proposal, agency shareholding and voting rights would reflect customer numbers and other factors. Paul Whittaker said that Transco has proposed its model on the basis that Transco bears the majority of costs and gets proportionate voting rights.

Keith Harris noted that under the current proposals, Transco would control the agency. He expressed concern that the agency might not fulfil its purpose of easing the administration of the whole industry if one party dominates the organisation. He noted that other successful models have adopted equal share ownership.

Chris Train said that even if shareholdings are based on customer numbers etc, voting rights don't have to reflect shareholdings. He said that in some circumstances it was inappropriate for Transco to have the dominant vote, for instance in relation to service delivery under the network code.

Chris questioned whether it would be in shippers' interests to have an ownership stake in the agent, given that company directors have responsibility for the conduct of the company and, in the case, the agent is responsible for carrying out gas transporter's obligations under the network code. Chris said that since the purpose of the agent is to deliver the duties of gas transporters, gas transporters need to be able to control it.

In response to a question from Simon Goldring, Chris Train said that the agency's set up costs would be funded using Transco's operational expenditure. He noted that xoserve would have its own financial accounts.

Sonia Brown asked group members to provide alternative approach to agency governance than the approach proposed by Transco by 28 May. She said that if no alternative proposals were received, then Ofgem would assume that DISG members were prepared to accept Transco's model.

ACTION: Group members to provide alternative approach to agency governance by Transco by 28 May.

6. Waters Wye paper on emergency procedures and other issues

The group agreed that this issue should be discussed at the CIWG meeting of 26 May.

7. Operational information flows

The group agreed that this issue should be discussed at the CIWG meeting of 26 May.

8. Credit risk on IDNs compared to RDNs

At the previous DISG, it was suggested that IDNs could be at greater risk of default that Transco businesses because the consequences of defaulting to Transco were considerably more severe than defaulting on an IDN. Chris Train suggested that this issue could be addressed via the adoption of a 'one out all out' arrangement. Sonia Brown noted that this approach could have implications for Ofgem's work regarding credit, and asked Transco to prepare a paper setting out their approach so that it could be considered in the context of Ofgem's credit review.

ACTION: Transco to prepare a paper on differential credit risk and its solutions.

9. Unmetered inter-LDZ transfers

The group agreed that this issue should be discussed at the CIWG meeting of 26 May.

Next meeting

The next meeting was scheduled for 10 am, 1 June 2004.