

## NGT Potential Sale of a Distribution Network

### Comments on the RIA on the Offtake Arrangements

9 July 2004

The Association of Electricity Producers welcomes the opportunity to comment on this regulatory impact assessment. We consider that consultation on this document provides an important opportunity to comment on the issues and various options under consideration. However we are disappointed that the views expressed by the workgroups are not more fully represented, particularly in respect of the role of shippers in booking NTS exit capacity. We are very surprised and concerned that Ofgem's preferred option is option 4; we fundamentally disagree with this view, for reasons outlined later. However we believe this approach would have a detrimental impact on the market.

The Association is also concerned that these options are considered at such a high level, and that it appears that a firm decision on which option to develop will be taken on this high level analysis. Whilst we accept that undertaking cost benefit analysis is challenging, and we recognise that it is not possible to ascertain the costs and benefits of these approaches with any degree of certainty we are concerned that the uncertainty in the analysis is not represented. In addition it is not clear if during the development process, issues come to light that would have an impact on the cost benefit analysis how this would lead to a re-consideration of the option chosen.

Ofgem has identified a number of key issues to be considered when addressing the options for the offtake arrangements, we provide comments against these:

#### **Key issues**

##### 1. Undue discrimination between networks

Ofgem considers that the arrangements should limit the opportunity for undue discrimination by Transco between retained and independent networks as this could lead to inefficient cost allocation and hence costs borne by customers. The Association agrees with this principle but we are concerned over the additional costs that might arise from complex arrangements aimed at preventing discrimination, when Transco already has licence conditions to prevent discrimination. It appears that Ofgem is expecting Transco to breach its licence, and it is not clear why it does not consider these licence conditions provide sufficient confidence in this area when Ofgem appears happy to rely on licence obligations in other areas.

Ofgem also notes that business separation is a key regulatory safeguard to ensure no undue discrimination, but does not explore the interaction between the options for business separation and the offtake arrangements. For example if legal separation is required to what extent does this affect the options for the offtake arrangements.

The Association considers that whatever arrangements are adopted they should be the minimum necessary to enable a DN sale to proceed and that the same arrangements should apply for RDNs as IDNs, including revenue flows to ensure that at future price control reviews effective like for like comparisons between networks, subject to the same contractual and commercial conditions, can be made.

##### 2. Undue discrimination between NTS offtake points

Ofgem considers arrangements should deliver a framework in which Transco is unable to unduly discriminate between DNs and other NTS offtakes. Whilst we accept

this principle we recognise that customers who are directly connected to the NTS are end users of gas and therefore different to DN offtakes that supply another pipeline network. Consideration should be given to this in developing the arrangements. It will also be important to ensure NTS directly connected customers are not subject to more onerous conditions than similar customers connected within the distribution network as this could create undue discrimination and potentially perverse incentives with respect to new connections.

The Association agrees that cost reflective charging is a key requirement that promotes competition.

3. Economic and efficient development and operation

The Association agrees that the arrangements should facilitate the economic and efficient development of the transmission system. We consider that efficient system planning and operation is best carried out between network operators so that they can take a holistic view of capacity requirements. We have serious concerns with shippers having a central role in influencing investment plans as we do not believe they will be able to predict their portfolio requirements three years in advance with any accuracy and shippers will have diverse views over the level of supply security that they are willing to commit to. We believe this could lead to an inefficient level of investment, either too much or too little, have security of supply impacts, be detrimental to competition and have distributional effects depending on the level of capacity booked.

4. Security of supply

The Association considers that security of supply is a key issue in developing the arrangements. We would not expect the HSE to agree to any safety case that had a detrimental impact on the security of supply. We consider that it is important to retain the 1 in 20 planning obligation on network owners

5. Effect on competition

We agree that the arrangements should protect and where possible promote competition. In this regard we consider competition in gas supply is of primary importance. We consider the promotion of competition in other more complex secondary services is something that should be led by the industry and its customers and not by Ofgem.

6. Accountability and regulatory involvement

We agree that the clear allocation of responsibilities will make parties accountable and the correct alignment of commercial incentives will reduce the need for regulatory involvement in decision making.

7. Governance of the offtake arrangements

We agree with the principles for the governance arrangements.

### **Options for allocation of NTS exit capacity**

As we expect the issues relating to a constrained or unconstrained allocation of capacity to be considered more fully in the regulatory impact assessment on the interruption arrangements we will comment on this issue in our response to that document. Although we note that options 2,3 and 4 assume requests for capacity will be met and are therefore based on an unconstrained approach to capacity allocation. We consider the fundamental

principles, costs and benefits of these options would change significantly if a constrained approach to capacity allocation were to be taken forward.

### **Option 1 – Transco’s initial proposal**

As this most closely reflects the existing arrangements within Transco, we consider this option has some desirable features. First it is the least cost to implement and does not require shipper involvement nor change to the charging arrangements. It also does not change the arrangements for customers connected directly to the NTS. These current arrangements seem to be working well and we cannot see a case for changing them. Also given that investment plans leading up to the next price control review will have already been determined before any sale completes it is not clear why new arrangements are required at this time.

The key weakness of this approach is that the decision on the level of NTS exit capacity to be made available at each offtake point lies solely with the NTS. This could be amended such that the NTS and DNs have a duty to co-operate and seek to agree an efficient level of capacity consistent with their 1 in 20 obligations. Whilst Ofgem would have a role in resolving disputes we consider it would be in the interests of the network owners to agree such that referral to Ofgem was only as a last resort. This approach seems to work well in the electricity market. This approach would also benefit from being of low cost to implement and not requiring any shipper involvement.

### **Option 2 – DN booking model**

This option gives a central role to DNs and NTS direct connects, in that the NTS must provide the capacity requested. We accept that this limits the potential for discrimination between networks but do not understand how this promotes competition for NTS exit capacity, as capacity requests must be met in full. Although we accept there might be competitive benefits between shippers where those that book less capacity incur lower costs, this would depend on them also accurately forecasting the winter severity too (see comments under option 3 and 4)

It is also not clear whether the NTS would retain the 1 in 20 obligation as the commentary on this option seems to suggest that the NTS will accept the request by the DN without further analysis, hence saving resources. We also consider that there is still some potential for disputes to arise since the NTS may not consider it is efficient for it to invest as requested by the DN and may therefore dispute this on this basis.

Ofgem notes that an incentive scheme will be required in order to ensure DNs do not over request NTS exit capacity. This will require the costs of an ‘expected level’ of capacity to be set. Clearly this will give Ofgem a significant role in determining what the efficient level of capacity is. It is not clear how this fits with minimal regulatory involvement, which is a theme in Ofgem’s commentary. Ofgem also expects the incentive scheme to recognise the trade off between DN investment and the required level of NTS exit capacity. Ofgem has recently explained (at CIWG on 7 July) that a DN could potentially alter its MDQ requests at each offtake point such that the NTS bears a greater proportion of the costs than the DN or vice versa, although we have no more information to understand whether this is possible in practice or just a theoretical concept. If this is a real issue, then in order for the incentive scheme to manage this it would appear that an ‘expected level’ would need to be set for each offtake point, which seems overly prescriptive. Alternatively if the DN made NTS exit capacity requests at specific offtake points that required greater investment by the NTS than an alternative set of numbers which would deliver a similar outcome in terms of aggregate

MDQ, this could give rise to disputes between NTS and DNs. We feel this supports our concern about any one sided capacity determination process.

Also in respect of the incentive scheme the DN would need to have an incentive in place in the timescale in which it is making firm requests for NTS exit capacity i.e. three years ahead. As the incentive generally forms part of the price control does this mean that price control reviews will have to take place on a timetable different to the current approach where price controls and incentives are agreed just before the period to which they relate.

Ofgem considers that a variant to this model could allow shippers to book NTS exit capacity directly. It is not clear under this model why a shipper would want to do this unless it felt there was a commercial advantage in doing so. As the DN would still be responsible for requesting capacity consistent with its 1 in 20 obligation, if a shipper were to book less than 1 in 20 for its sites the DN would have to book an additional amount and distributional effects could arise. Given the complexity that stems from this variant the Association does not consider this should be pursued.

### **Options 3 and 4 – Shipper and DN booking and shipper booking models**

The Association considers that giving shippers a key role in determining network investment is likely to lead to an inefficient outcome, increase the risks to security of supply and be detrimental to competition in gas supply.

Competition in gas supply in the UK is well developed and customers can move freely between suppliers, therefore supply contracts are typically of one year duration. This means that shippers will be unable to predict with any accuracy their portfolio requirements in three to five years time. Shippers will have different attitudes towards risk in respect of the winter severity they book capacity for. This will be heavily influenced by the overrun regime. Successful shippers will be those that most accurately predict the capacity requirements of their customers but also those that are lucky enough to have predicted the severity of the winter three to five years ahead. Those that underbook against the actual winter conditions will incur overrun charges, which presumably will have to be set at a fairly high level in order to encourage shippers to book capacity in the first place. For smaller suppliers these charges could pose a threat to their business. Shippers that take a more conservative approach and book capacity for more severe winters will have a higher cost base and be less competitive than risk taking shippers, but will be protected from overrun costs and are more likely to stay in business in the longer term. We do not consider it is appropriate to develop arrangements that reward shippers for taking a 'risky' approach to capacity booking when the success of the approach will depend on the weather, rather than other factors that shippers may have some degree of influence or control over. Such as: balancing performance, customer service, internal costs etc... Furthermore, such an approach is highly unlikely to result in robust investment signals for the network operators or the development of economic and efficient networks.

As option 4 provides a direct link between shipper booking and investment, if shippers were to adopt an aggressive 'risky' approach to capacity booking, in the long run this could lead to less investment in the network. This would lead to deterioration in security standards and an increased risk of a national or local gas supply emergency. We therefore consider it unlikely that the HSE would approve a safety case where the responsibility for security standards resided with shippers, over whom they have limited regulatory powers.

We are not convinced that UIOLI rules or secondary trading of capacity rights will be an effective means of ensuring these arrangements do not create barriers to entry and enable

shippers to be able to obtain capacity rights in timescales consistent with their customers' needs.

In addition it is not clear how option 4 would be compliant with the EU Gas Security Directive, which comes into force on 19 May 2006 and says that:

- roles and responsibilities of different gas market players must be defined in achieving policies with respect to adequate levels of security of supply
- adequate minimum security of supply standards must be specified
- security of supply standards shall be published
- security standards should be 1 in 20 at least for domestic customers

Alternatively if shippers took a more risk adverse approach and booked the aggregate SOQ of their expected portfolio, this could lead to over investment in the network which would be inefficient and lead to increased costs to customers. This approach would also not take account of diversity of demand within a network. Even if shippers had a good understanding of their current customers' demand, they may be reluctant to book lower levels of capacity to take advantage of diversity as this diversity may no longer be a feature of their portfolio in three years time. In any case diversity within an individual shipper's portfolio within a zone is likely to be very limited, therefore we consider that diversity is best considered and accounted for at the network level, since the network owner will have a better understanding of this and not be subject to portfolio changes in the way that shippers are.

A feature of option three is that the DN books additional 'top-up' capacity to ensure there is sufficient capacity to meet 1 in 20 requirements. This would mean that the risks to security of supply under option 3 are lower than under option 4. Ofgem have recently clarified that the costs of this additional capacity will be charged back to shippers. It is our view that the way in which this is implemented is likely to create distributional effects that are detrimental to competition, such that any benefits that might arise from shippers signalling their capacity requirements are undermined.

### **Options for diurnal storage and operational flows**

The Association supports the administered approach to the allocation of diurnal storage and operational flows. We consider that the existing arrangements have been based on relevant operational experience over a period of time and we do not believe that it is necessary to introduce complex commercial arrangements for the allocation of these rights, nor is it required for a sale to proceed.

We also note that the offtake rights associated with NTS direct connects are detailed in the relevant NExA, and we would expect these to be preserved following any sale of a distribution network. In addition we are concerned that if commercial arrangements were introduced for the allocation of diurnal storage on the NTS this would result in different arrangements for customers connected to the NTS and DN which could have distortionary effects on associated markets.

### **Options for business separation**

The Association supports full legal and structural separation as we consider this will provide the greatest safeguards, limiting the potential for discrimination between networks. Ofgem has stated that if this option is chosen the associated costs will not be passed on customers.

We would like to seek assurance that customers will be protected from the ongoing costs of legal and structural separation at future price control reviews and not just the initial costs.

### **Assumptions underpinning cost benefit analysis**

As stated above we agree that undertaking cost benefit analysis is challenging and accept that assumptions have to be made, however we consider the analysis is flawed in a number of respects:

- 1) We consider that the costs and benefits of each option should be considered in absolute terms rather than relative to a base case. This would facilitate a more balanced consideration of the 'base case' and help to highlight the most important areas of concern to justify why reform is necessary
- 2) The assumption that each shipper will only require 0.25 FTE additional staff for options 3 and 4 is in our view too low given that each shipper will need to develop processes for forecasting their capacity requirements, undertaking sensitivity analysis and risk assessment to establish what levels it might require, to actually reserve that capacity, to trade that capacity in the short term. 1.0 FTE might be a more appropriate estimate.
- 3) There is an assumption that Transco will discriminate between networks; causing the IDNS to undertake more investment than if the discrimination had not occurred. We do not believe that this should be stated as a definitive outcome as Transco would risk being found to be in breach of its licence if it had acted in favour of the retained networks. We would therefore assign a relatively low probability to this potential cost avoided becoming a benefit.
- 4) We do not agree that requiring generators to purchase additional flexibility over and above that provided by the existing arrangements will lead to lower electricity balancing costs

To summarise, The Association:

- does not support options 3 and 4 for the allocation of NTS exit capacity
- considers that 1 in 20 obligations are important to ensuring security of supply
- believes network operators are best placed to ensure 1 in 20 obligations are met
- supports an administered approach to the allocation of diurnal storage
- supports legal and structural separation