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**Date** 9 July 2004

Dear Sonia

**National Grid Transco – Potential sale of gas distribution network businesses: offtake arrangements**

Thank you for providing EDF Energy with the opportunity to respond to Ofgem's Regulatory Impact Assessment (RIA) of Offtake Agreements relating to the proposed DN Sale. We agree with Ofgem that the objectives of the process are to limit undue discrimination between networks and NTS offtake points, to ensure the economic and efficient development of the transmission system, and to promote effective competition, whilst maintaining security of supply for end users.

On a general point, we do not believe that option 1 should have been selected by Ofgem as the baseline option to assess the costs and benefits of the other offtake options. EDF Energy believes that the status quo should have been used as the baseline, because the sale has not gone through yet and therefore the industry should be analysing whether there are any benefits to be gained compared with current arrangements, rather than pre-empting the process in this manner. Performing a RIA from the standpoint of option 1 distorts the process of evaluating the costs and benefits of different options.

**Options for the allocation of NTS Exit capacity**

EDF Energy notes that all four options presented by Ofgem are quite similar in terms of who books NTS Exit Capacity (NEC) and how it is allocated. The main differences are in respect of where the obligations lie, in terms of meeting licence obligations to secure enough capacity to meet the industry's demands. We believe that the 1 in 20 licence obligation on behalf of the DNs should not be removed, since we are concerned that this may lead DNs to calculate

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incorrectly and book NEC which may lead to under investment on behalf of the DN. This could ultimately lead, therefore, to an increased risk of emergency situations. In this respect, we do not believe that option 4, where the DNs' 1 in 20 obligation is removed and Shippers are ultimately responsible for booking NEC, could work in practice or guarantee security of supply. It would be difficult to see how the HSE could approve such an option.

### *NEC booking timescales*

EDF Energy does not believe that booking firm NEC three years out will be economic or efficient or provide the valuable investment signals that they set out to achieve. This is because it will be difficult for Shippers to predict the levels of NEC they will need more than 1 year out in view of the erratic nature of supply portfolios in such a competitive market place. While we can appreciate the need for strong investment signals in order for transporters to meet their planning and investment horizons, we can not see any meaningful signals emerging as Shippers would be cautious about buying capacity that far out when their demand portfolios are not certain. We make reference to the Long-Term Entry Capacity auctions, which have not provided strong investment signals further out than two years, despite Producers having investment timelines of 15-25 years.

We do not believe the industry needs another Long Term capacity auction for Exit capacity, but recognise that one might be necessary if we were to go down this route, as NEC would be changing hands frequently throughout the 3 year period as Shippers' portfolios change. We believe that the current system of booking for NEC for 1 year is the most sensible option at the moment, as it would cause the least amount of disruption to the industry should the sale go through.

### *Option 1*

EDF Energy agrees that Option 1 would be the least costly to implement, as it closely resembles current arrangements and no changes to charging arrangements would be needed. However, we recognise that the downside is that the NTS operator would be likely to discriminate between Retained DNs (RDNs) and Independent DNs (IDNs), as the NTS determines and allocates the Maximum Daily Quantities (MDQs) requested by all DNs. We agree with Ofgem that this option could lead to a tendency for DNs to over-request capacity, which could lead to over-investment by the NTS, thereby jeopardising the economic and efficient development of the network. For these reasons, we do not believe option 1 should be pursued.

### *Option 2*

EDF Energy believes that option 2, where the DN and NTS direct connects would be able to book and pay for exit capacity, would be the most efficient and economic option for industry participants and provide the most benefits to end-users. This is because Local Distribution Zones (LDZs) currently compile their own demand forecasts and the resources therefore already exist and indeed would even be minimised, as the NTS will accept the NEC requests from DNs without having to undertake further analysis and assessment.

We agree that responsibility for setting NECs would lie with the DNs and NTS direct connects, who determine the level of NEC required at each offtake point, which could lead to over-requests for NEC and NTS investment as in option 1. However, the natural tendency for DNs to request higher than required levels of NEC should be limited by the incentive scheme, which should align the commercial incentives of DNs with those of its end customers. We also believe that this option would minimise the scope for discrimination between DN and direct NTS offtakes as they would both be able to request the level of NEC that they require rather than having this determined on their behalf by the NTS.

EDF Energy also believes that regulatory involvement would be minimised as there would be clear and distinct lines of responsibility for determining and booking NEC levels by the DN, minimising the likelihood of disagreement between DNS and the NTS. However, we believe that Ofgem would have to intervene where the NEC requested by the DN did not match the NTS view from the analysis undertaken through the Transporting Britain's Energy consultation.

Under the variant to Option 2 suggested by Ofgem, where the DN Shippers could by-pass the DN and request their NEC requirements direct from the NTS, we have concerns that this could prove difficult to administer in practice. This is because the DN involved would have to know for which sites the shipper had booked capacity and how much, so that it could plan and adjust its bookings accordingly. If the shipper were to under-book, the DN would be ultimately responsible for ensuring enough capacity was booked to meet its 1 in 20 obligation. We can only assume that there would be a charge associated for not meeting their requirements but cannot see how this charge could be set and smeared back across DN Shippers. This could create the possibility of cross subsidy between DNs. We would like to know if Ofgem has considered this possibility or identified any potential remedies.

#### *Option 3*

EDF Energy recognises that this option is similar to the second variant of Option 2 and therefore has some merit. However, because of their similarities, the problems highlighted above, with Shippers having to directly book NEC 3 years out, which gives rise to the possibility of shippers booking incorrect NEC amounts, could be exacerbated. However, we agree with Ofgem that this option, where DN Shippers and NTS directly connected Shippers would be responsible for requesting levels of NEC, would produce the least amount of benefits because of the extra costs associated with Shippers taking on the new task of dealing directly with the NTS. Also, the diversity advantages that this option produces from the shipper to shipper competition for NEC could be easily offset by the effect of 3 year long-term contracts, since Shippers may want to tie in customers for longer periods, which could harm competition.

#### *Option 4*

EDF Energy recognises that this option, which is a radical version of option 3 where only shippers book NEC directly and keep the responsibility for maintaining 1 in 20 obligation, would provide considerable benefits to customers because of the strong commercial incentives on shippers. However, the

success of this option would depend on how accurately shippers were able to predict their NEC requirements 3 years out. It would also be difficult to see how the HSE could approve the DN's safety case, as mentioned above.

Therefore, we do not believe that option 4 would be efficient in practice or manageable, because of the DN Licence changes that would need to be implemented in order to remove the 1 in 20 obligation from DNs. Also, we believe that some sort of exit capacity auction mechanism would be needed for option 4 to work correctly but we are concerned that this would increase the industry's costs without any real added benefit. However, we believe there is merit in discussing this option further in the event that the DN sale got the go-ahead.

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

EDF Energy believes that option A, the administered approach, where rights to diurnal storage and operational flows are allocated in accordance with rules that are based on Transco's existing internal procedures, would be a more effective and efficient option in the short run than B, the commercial approach. While we recognise that there are considerable cost savings and advantages arising from option B, due to the introduction of extra flexibility and the possibility of a secondary market for these services, we believe that the industry will be paying twice for this service. This is because, at the moment, DNs do not have a commercial contract with Transco for this service and yet Shippers pay for Transco's balancing actions. If a commercial layer were added to this area, this would mean the industry would be paying for NTS linepack flexibility, once through balancing charges and again through the DNs' flow charges, which would ultimately be passed through to shippers. This is a risky approach and we believe that Ofgem should not pursue this option.

At the same time, while we recognise there may be some cost savings identified, we believe that benefits of £11.7m are not particularly significant and that industry costs could be quite significant to set up the systems and processes to administer option B.

We note that the operational parameters in NeXAs (Network Exit Agreements) are similar to those that exist offshore between Producers and Terminal operators/ Shippers. We note that these offshore transportation agreements work in a similar way to NeXAs, are flexible and do not include any charge for different types of flow rates. Normally, best practice dictates how much the Operator, the Offshore Producer in this case, can flow onto the system. We recognise that Option A allows room for undue discrimination on behalf of the NTS operator but believe that Transco's licence obligations not to discriminate between DNs/offtake points should ensure the correct behaviour. We therefore, feel that for the time being Transco should adopt this regime, until perhaps the next price control, when more efficient measures could be designed and discussed.

## **Business separation**

EDF Energy notes that there are ultimately three types of options for business separation: Transco's option (option A), Structural separation (Option B) and full legal and structural separation (option C).

We do not believe that Option A, where Transco retains its existing level of business separation between NTS and RDNs, with further safeguards such as targeted rules and licence conditions, would provide the levels of guarantees and comfort that the industry would need should the sale go ahead. We agree with Ofgem's view that extra commercial incentives and obligations would only complicate the regulatory regime and result in a less efficient system operation, since Transco could potentially have a commercial advantage in how it treats its RDNs versus IDNs.

We believe that Option B has more merit than option A in meeting the relevant objectives of Transco's licence conditions. By separating the operation and information through physical separation, Transco would be limited in the way it could preferentially treat its RDNs and thus limits undue discrimination. However, we recognise that under this arrangement it would still be difficult to demonstrate that the NTS has behaved in a non-discriminatory manner. For this reason, and to allay the concerns of potential DN owners and NTS Shippers, we believe the only route to take is through option C, legal and structural separation.

Under option C, in addition to Option B, the NTS and group of RDNs would be in two separate legal entities, with separate GT licences, and this would place them on a level playing field with IDNs. We recognise Transco's concerns that this option could be costly, as it might have an adverse effect in the long-run and increase its average cost of debt, to the detriment of customers. However, we note that Ofgem has undertaken considerable research in this field and feel that there are practices and arrangements such as the provision of upstream guarantees to bondholders, which would mitigate Transco's exposure to increases in its future cost of debt.

EDF Energy, therefore, supports legal separation, as this is most likely to reduce the potential for undue discrimination between RDNs and IDNs, and on the basis that costs are not passed on to consumers.

## **Further queries**

We wonder whether NEC and Distribution EC would be site specific or equal the aggregate amount of capacity required for each network. If it were site specific then we would not envisage either option 3 or 4 working properly, as there would be little competition for other Shippers' offtake points.

I hope you will find these comments helpful. If you would like to discuss any of them, please contact John Costa on 020 7752 2522, or myself.

Yours sincerely

A handwritten signature in black ink, appearing to read 'D. Linford', written in a cursive style.

**Denis Linford**  
**Director of Regulation**