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

Response by E.ON UK

Offtake Arrangements Regulatory Impact Assessment

Overview

E.ON UK continues to believe the proposed sale 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). We are however less convinced that there is much to be gained from focusing too much effort, at this time, on fundamental changes to the offtake regime (particularly those proposed under Options 3 and 4).

In our view the scope for discrimination between networks and sub optimal network operations arising form the choice of offtake arrangements is overstated in the regulatory impact assessment (RIA). E.ON UK considers that within the current price control period that the administered arrangements set out in Option 1, which are similar to the existing offtake arrangements are adequate for day 1 post DN sales, but that from the start of the next price control period administered pricing arrangements should be considered to fairly allocate the cost of diunal flexibility between the networks. This offers the most expedient and necessary way forward to facilitate the sale of DNs, without introducing additional complexity into the regime at this stage. The suggested market based approach for valuing diurnal storage (Option B) does not in our view offer any advantages over an administer price solution, an option which does not seem to have been considered in the RIA.

Adoption of either Option 3 or 4 would, in our view, add significantly to shipper and regulatory costs, whilst potentially undermining security of supply and leading to undue discrimination between customers based on the type of network they happen to be connected to. We consider that this last factor should be considered as an additional assessment criterion in the RIA and we have therefore included this in our comparative assessment of options set out in Appendix 1 and 2 of our response.

On the matter of business separation, we consider this to be a matter of primary concern to Transco and the prospective buyers of DNs. That said Option 2 requiring internal structural separation but stopping short of full legal separation would, in our view, prevent potential discrimination in Transco's treatment of retained distribution networks (RDNs) compared to the newly independent distribution networks (IDNs) but at reasonable cost.

In summary we consider a relatively simple administered offtake regime combined with internal business separation without division into individual legal entities combined with cost reflective pricing of diurnal flexibility between networks from the next price control, will yield the most net benefits for customers. In our view the more radical proposals suggested by Ofgem risks seriously undermining the current trading arrangements in pursuit of theoretical gains that are unlikely to be realised.

Options for the allocation of NTS exit capacity

For convenience we have chosen to summarise our views in a similar format as Ofgem. Please refer to Appendix 1 attached for a summary of E.ON UK's evaluation of options for the allocation of NTS exit capacity.

Options 2, 3 and 4 in theory offer more protection against undue discrimination between networks and economic and efficient network operation and development. In practice however, we think these issues can be best addressed through adequate internal separation arrangements ('chinese walls', controlled access to information etc.) together with adequate visibility of relevant planning and operational information. Provided Transco (both NTS and RDNs) and IDNs publish accurate data in relation to physical network and offtake capacities as well as the availability of diurnal storage in their respective systems, it should be feasible for discrimination concerns to be investigated. Ofgem will necessarily be supplied with and seek to verify this data as part of any price control discussions with transporters. Such data will indeed form the basis of any capacity incentive arrangements that we assume will be established by the regulator with each transporter.

We are not convinced that the complex arrangements (Options 2 or 3) involving shippers separately booking exit capacity would offer any more benefits over accurate disclosure of physical system capabilities between network owners and indeed network owners and Ofgem.

Shippers are in the business of trading, balancing and supplying gas. Shippers are only interested in capacity arrangements to the extent that such arrangements impact their shipping of energy. Fortunately the current NTS exit arrangements provide for the 'automatic' booking of exit capacity for LDZs based based on aggregate shipper supply point offtake quantities (SOQs) for each shipper in a given LDZ. This arrangement was introduced under a network code modification in 1998 to relieve shippers from the onerous task of separately booking exit capacity (a process that invariably involved greater risk from potential overrun penalties than the benefits that could ever be obtained from the optimisation of exit capacity bookings). The current arrangements are therefore simply an accounting process to allocate exit capacity charges amongst shippers that has no relevance to the level of physical capacity provision by network owners.

We would prefer for the industry to continue to rely on the 'tried and tested' planning process between the NTS and DNs, rather than seek to distort the current 'automatic' capacity booking mechanism for shippers. It remains unclear to us whether firstly this 'automatic' process would also be abolished under Option 2, the DN booking model, and secondly to whom overrun charges would be payable (Options 2A or 2B). We have therefore assumed shippers would have to make some on-off system changes and incur additional on-going administration costs amounting to an NPV of up to £4m for Option 2.

We also consider security of supply might be reduced under Options 3 and 4 because it is unclear which entities are driving investment in NTS exit capacity or whether this conflicts with the 1 in 20 obligation placed on transporters. Also under these options we consider that far from reducing regulatory involvement the sheer complexity of these arrangements necessarily requires more regulatory management and oversight. The growth in Ofgem's budget allocated to "market development" over the last 5 years is perhaps the best indication that complexity of market rules drives the level of regulatory involvement.

Our greatest concern about Option 3 and 4 however is that undue discrimination will arise between customers on the basis of what system a user happens to be connected to. This could in turn impact supply competition and security of supply in gas, and electricity (in so far as it affects power station operations).

The consultation makes inappropriate comparisons between 'real ' customers (i.e. NTS direct connects and DN offtake points). DN offtake points are demarcation points between networks through which gas passes on route to 'real' customers that are connected to DNs. The proposals once combined with so called market mechanisms for allocation of diurnal storage in the NTS would, in our view, lead to NTS supply points being treated differently to equivalent size supply points within a DN where NTS diurnal flexibility is necessarily shared with all other customers in that DN.

Compared to other customers, real time telemetered NTS supply points already face the most rigorous treatment amongst existing customer types and in fact make the least use of the flexibility across the whole system, whilst providing the most accurate and reliable offtake data to the system operator Transco. Reding between the lines it would seem that NTS direct connects could ultimately end up bidding for exit capacity rights in competition with DNOs and also face an extra charge for diurnal flexibility. NTS supply points currently receive an already tightly constrained diurnal flexibility service as part of a 'bundled' transportation service. It is this 'bundled' service which allows NTS direct connects to offtake gas at variable rates throughout the day, something one would assume would continue to be offered as a 'bundled' service for similar size supply points connected to DNs.

Options for treatment of diurnal storage and operational flows

Transco's proposed administered arrangements for dealing with the sharing of diurnal storage between the NTS and DNs seems broadly acceptable for the foreseeable future and it certainly seems adequate until the end of the current price control which assumes particular levels of investment in the NTS and DNs.

It is however important to dissuade DNs relying unduly on the NTS for diurnal flexibility in the medium and longer term. It is cheaper for DNs to provide diurnal flexibility within the DN than to get Transco to invest in additional NTS capacity for that purpose. It is therefore important from the next price control to properly price the value of flexibility provided by the NTS to each DN. It will be important to avoid Transco providing free diurnal flexibility to its RDNs in an environment in which economics may dictate that existing diurnal flexibility is squeezed. We would therefore support the establishment of administered price arrangements solely between the network operators to fairly cost that flexibility. This is not the market based auction approach, which seems to be implied under Option B.

We have called the administered price option between network operators Option A1 and E.ON UK's assessment of that approach is set out in Appendix 2. We agree that there is relatively low risk of undue discrimination between the networks under Option A from the next price control, hence we agree with the NPV benefit that Ofgem assigns to Option B under this criterion. We consider this benefit can equally be achieved under the administered price Option A1.

In our view, there are no significant benefits or costs to distinguish between the options in respect of economic and efficient network operation and development. Ofgem consider that benefits will accrue from more efficient gas balancing. This seems to come from more rigorous enforcement of gas offtake restrictions at NTS direct connects or DN offtakes. This suggests that current arrangements are significantly sub optimal. Deviations from allowed flow rates at NTS direct connects, are in fact already carefully monitored by Transco and tight restrictions (ramp rates and rate change notice periods) that reflect physical system limitations are imposed. With prior permission from Transco users can have some leeway to vary flow rates more quickly but Transco does not allow this if it has concerns about its abilities to residually balance the system. In the light of

this, the suggested £3.3m benefit from improvements in gas balancing is in our view unlikely to be realised.

The consultation paper seems to suggest that some flexibility for NTS direct connects is currently being withheld by Transco. As explained above we have no evidence to suggest that that is the case. Consequently we do not see how a £5.7m NPV benefit for the reduction of electricity balancing costs can be achieved as the gas to fuel such generation is already being made available by Transco when required.

As stated previously, save for technical constraints, we cannot see the justification for adopting a regime that seeks to discriminate between customers in terms of how they offtake gas purely because of the part of the GB gas transportation system they happen to be connected to. It is therefore essential that whatever offtake regime is ultimately adopted focuses purely on the direct physical interactions between the networks rather than adopting mechanisms that indirectly lead to a degradation of service to particular classes of customer.

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E.ON UK
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Appendix 1

Summary of evaluation of options for the allocation of NTS exit capacity

Issue	Option 1	Option 2	Option 3	Option 4
No undue discrimination between networks[1]	×	✓	✓	✓
Economic and efficient network operation and development[1]	×	✓	✓	✓
Security of supply[2]	✓	✓	×	××
Effect on competition[2]	✓✓	✓✓	×	××
Accountability				
• Less regulatory involvement[3]	✓	✓	× -£2.5m	×× -£5.1m
• Implementation cost[4]	✓	× -£4m to £0m	×× -£8.5m	×× -£8.5m
No undue discrimination between customers[5]	✓✓✓	×	××	×××
Net increase in potential benefit relative to Option 1	**£0m**	**> -£4m**	**> -£11m**	**> -£13.6m**

[1] E.ON UK is not convinced that there is significant scope for discrimination between networks and/or sub optimal network operations as a result of the choice of NTS exit capacity allocation arrangements.
[2] Ratings reflect the view that moves towards unnecessarily complex offtake arrangements may potentially undermine security of supply and create more fragmented wholesale and retail markets.
[3] More complex arrangements are considered to involve a requirement for more regulatory management and oversight.
[4] Ofgem estimated shipper costs for Options 3 and 4 seem reasonable, however we consider Option 2 to involve some additional shipper costs as well.
[5] Ratings reflect concerns about undue discrimination between customers based on whether they happen to be connected to the NTS or DNs. This could in turn have implications in terms of competition and security of gas and electricity supply.

Appendix 2

E.ON UK summary of evaluation of cost and benefits of diurnal storage and operational flows options

Issue	Option A	Option 1A	Option B
	Administered arrangements – no charge	**Administered arrangements – including charging at DN offtakes**	**Full market based arrangements NTS for all DN offtakes**
No undue discrimination between networks	✓	✓✓ £2.7m	✓✓ £2.7m
Economic and efficient network operation and development[1]	✓	✓	×
Security of Supply	✓✓	✓✓	×
Effect on competition	✓	✓	××
Accountability			
▪ Less regulatory involvement	✓✓	✓✓	××
▪ Implementation cost[2]	-	-	×× -£0.5m
No undue discrimination between customers[3]	✓✓	✓✓	×××
Net increase in potential benefit relative to Option A	**£0m**	**£2.7m**	**£2.2m**

[1] E.ON UK is not convinced that there is significant scope to improve the balancing efficiency in either the gas or electricity markets. Indeed further restrictions on users directly connected to the NTS under Option B could hinder their ability to offer flexibility into both markets.

[2] Shippers would face extra costs associated with any diurnal storage bidding processes for NTS direct connects.

[3] Ratings reflect concerns that NTS connected customers will face a harsher operational regime compared to equivalent sized users that happen to be connected to a DN. This in turn could have implications in terms of competition and ultimately security of gas and electricity supply.