

Sonia Brown
Director, Transportation
Office of Gas and Electricity Markets
9 Millbank
London
SW1P 3GE

Chris Train
Director – Network Sales

chris.train@ngtuk.com
Direct tel +44 (0)1926 655667
Direct fax +44 (0)1926 656563

9 July 2004

Dear Sonia

Offtake Arrangements Regulatory Impact Assessment - NGT Response

We welcome the opportunity to comment on this Regulatory Impact Assessment, which considers options for NTS offtake arrangements required if we were to sell any of our Gas Distribution networks. This response outlines our views on:

- options for exit capacity allocation at NTS offtakes, which are supported in Appendix 1 by our initial thoughts on the introduction of a commercial regime based on Option 2B in the RIA;
- options for the treatment of diurnal storage and operational flows, which are supported in Appendix 2 by our initial thoughts on the commercialisation of these services in line with Option B in the RIA; and
- the appropriate level of separation between the NTS and Transco's retained DNs, which are detailed in Appendix 3.

The offtake arrangements will form a significant part of the commercial and regulatory framework necessary to facilitate the sale of one or more Distribution Networks (DNs). This response describes how we envisage a progressive implementation of the arrangements consistent with the timescales for industry consultation together with the development of business rules, legal drafting and supporting systems.

Proposals for NTS Exit Capacity – Option 2B

We continue to regard Option 1 as a workable Day 1 solution which, by replicating current proven arrangements, has the additional merit of providing the widest possible platform for a transition to longer-term arrangements which could be developed in response to any commercial issues observed at the NTS/DN interface. We believe that concerns over undue discrimination and inefficient investment under Option 1 may have been overstated in the RIA, and therefore may not warrant the cost and complexity of the proposed commercial solutions. For example, similar arrangements to Option 1 have operated for the past 14 years in electricity industry across the NGC/DNO interface without major issues arising.

However, to the extent that Ofgem and the industry conclude that the issues raised by Ofgem are material and warrant the development of a commercial solution, we would propose that greater benefits and safeguards could be delivered if Option 2 (involving DNs booking the required NTS exit capacities) were implemented in preference to Options 3 or 4. Accordingly, we would propose

that further work is undertaken to develop Option 2 with a view to ensuring it can deliver a viable proposition.

More specifically, we believe that Option 2B, involving payments for NTS exit capacity between shippers and NTS (and not DNs) could be developed further as this is consistent with the existing commercial and regulatory framework for gas transportation, whereby licensed shippers enter into transportation arrangements with gas transporters. In our view, any alternative option enabling DNs to contract directly with NTS for transportation arrangements under the (Uniform) Network Code would require substantial review and reworking of the current regime. Accordingly, we would be content to move forward on the basis of Option 2B and we have begun to consider the development of modified offtake proposals along these lines.

Implementation of Option 2B

We agree with Ofgem that the benefits delivered through the adoption of Option 2B may include:

- A reduced potential for undue discrimination by NTS between DNs.
- Potential for enhanced economic and efficient network operation and development through additional investment signals provided by DNs.
- Preservation of the current 1 in 20 security standards for gas transportation.
- Enhanced effect on competition through greater consistency of treatment of all NTS exit capacity.
- Reduced regulatory involvement in capacity allocation process, although this is likely to be significantly offset by the need for regulatory involvement in setting incentive scheme parameters for DNs in booking efficient levels of capacity and for the NTS in setting baseline parameters for an exit capacity release mechanism. This would effectively place Ofgem at the centre of the investment planning process.

In addition, Option 2B affords greater opportunity for timely implementation (other than Option 1) as it could be accommodated within the existing commercial and regulatory framework for gas transportation. However, we note that substantial development of systems and codes will still be required.

We have developed an outline implementation plan involving phased introduction of Option 2B consistent with the need for industry consultation, the development of business rules, and the IT system development requirements. Our initial view of how these arrangements could work, together with the timing and features of each stage of implementation are set out in Appendix 1. Our proposal would look to introduce arrangements in 2005/06 whereby DNs and NTS direct connect shippers would be required to book their exit capacity requirements from 2008/09 onwards. Baseline capacity allocations would be fixed for the NTS, and incentives introduced to release incremental exit capacity thereafter. DNs would be incentivised to book an efficient level of capacity necessary to meet their 1 in 20 obligations, supported by overrun charges to discourage under-booking. Given typical investment lead times of 2-4 years, all investment in exit capacity sanctioned from 2005/06 would be subject to these commercial incentives, thus we believe, delivering Ofgem's objectives in full.

Due to investment lead-times, exit capacity for 2005/06, 2006/07 and 2007/08 is essentially fixed in line with Transco's existing planning process, and accordingly the introduction of commercial arrangements for booking exit capacity for those years would offer little additional benefit. Also, the development of interim commercial arrangements and associated IT systems would require extensive development at potentially significant cost. The practical implications therefore suggest that it would be more appropriate to focus effort and expenditure on delivering the full regime. To the extent that there is a shortage in capacity during this period and concerns are raised over the allocation of this capacity between DNs, capacity would be allocated transparently according to procedures set out in the Offtake Code. However, the requirement for DNs to book forward exit capacity from 2005/06 would signal the relative value DNs place on expanding this capacity from

2008 (compared to investment on their own networks), and so efficiently inform the NTS of the need for investment (or otherwise) to deliver additional exit capacity.

Finally, adoption of Option 2B would require the inclusion of all commercial arrangements between shippers and transporters associated with NTS exit capacity within the Uniform Network Code (UNC). However, we believe that an Offtake Code would be required as an ancillary document to the UNC to define the aggregate NTS exit capacity requirements of the DN, information flows, the sharing of connection assets, emergency procedures etc. The Offtake Code would also be the operator-to-operator agreement necessary to ensure the safe mutual operation of adjoining systems in a way that enables those respective operators to meet their respective obligations under UNC.

Overall, to the extent that commercialisation of the offtake arrangements are considered necessary, we believe that the Option 2B approach to allocating NTS exit capacity as presented in Appendix 1 would provide a viable basis for the development of workable offtake arrangements.

Views on Options 2A and 3

Options involving DNs setting and paying for NTS exit capacity under Options 2A and 3 require careful further consideration as these appear to be inconsistent with the current statutory framework, which requires entities entering into transportation arrangements with gas transporters to be licensed shippers. There may be solutions within the existing framework, for example via an exemption to Section 7(2) of the Gas Act, that would render these options viable. However, it is our preliminary view that implementation of these options would also require significant additional changes to the Network Code, price control and transportation charging. Accordingly, our preference is to work towards Option 2B, which we believe would deliver Ofgem's objectives without the need for such extensive changes to the current statutory, regulatory and commercial framework.

Views on Option 4

We do not believe that Option 4 could offer a viable solution for informing the long-term development of a secure GB transportation network. As Ofgem are aware, we have particular concerns regarding:

- The removal of the 1 in 20 obligation and the implications for security of supply
- The accuracy of investment signals provided by shippers three years out and at specific locations (individual NTS/DN offtakes). Inaccurate signals would lead either to inefficient investment (in both the NTS and DNs) where capacity requirements are over-forecast, or security of supply concerns where under-forecast. DNs, with better knowledge of aggregate loads physically connected to their network are far better placed to signal their capacity requirements, compared to shippers who face uncertainty and fluidity in their forward looking customer portfolio and accordingly are unwilling to make firm long-term commitments.
- Shipper bookings of NTS/DN Offtake capacity requirements would appear to require further changes to the commercial and operational regime on both the NTS and DNs, potentially involving shipper gas flow nominations at NTS offtakes and intra-DN locational transportation charges.
- The extension of this model (i.e. shippers alone specifying requirements from the NTS) to diurnal storage and operational flow services provided by the NTS is problematic. It is difficult to conceive how shippers might have sufficient knowledge of DN requirements at the NTS/ DN interface to specify such requirements.

Consistent with these concerns, we do not believe there is any merit in the additional Option 2 feature allowing shippers the opportunity to book DN exit capacity directly from the NTS if they should wish to do so. We believe that, with this additional feature the option becomes a variant of Option 3, and accordingly this feature is not included in our Option 2B proposal.

NTS Pipeline Security Standard

The 1 in 20 pipeline security standard currently applies to Transco as a whole (both NTS and DNs). The RIA makes reference to the 1 in 20 obligation (if any) residing with the DN, but there is no explicit mention made of the NTS in this context. We believe that the NTS should continue to be developed in accordance with an appropriate pipeline security standard to provide confidence to the market that the at least the current 1 in 20 standard of pipeline security will be maintained throughout the gas transportation chain. Under the Option 2B proposal, this could be achieved by having NTS obligations that would involve it building capacity in response to investment signals received from the DNs (i.e. the exit capacity booked to fulfil their 1 in 20 obligations) and from NTS direct connect shippers.

Diurnal Storage and Operational Flows

We continue to believe that our original proposal (Option A) constitutes a workable day 1 solution that would provide a platform from which offtake arrangements for secondary capacity rights could evolve.

However, we agree with Ofgem that there may be some merit in providing DNs the opportunity to signal their needs and willingness to pay for diurnal storage capability. This would allow the NTS to invest in diurnal storage capacity if this is more efficient than a DN investing in storage capacity on its own network. Alternatively, DNs would be able to invest to reduce their reliance on the NTS for diurnal storage if it could do so more efficiently. Accordingly, we believe that there is some merit in considering the commercialisation of this service under Option B, so long as the benefits of such arrangements warrant the cost and complexity that they might entail.

Considerable development work will be necessary in terms of product definition under this option, and Appendix 2 provides our initial thoughts on how this might work should an Option B type solution be considered as the appropriate way forward. This option could entail arrangements whereby DNs and NTS direct connect shippers begin to signal their future diurnal storage requirements from 2007/08 and beyond. Any investment undertaken by the NTS to provide diurnal storage thereafter would be subject to the commercial incentives provided by these signals. Accordingly, we believe that such investment would be undertaken in an efficient, non-discriminatory manner, thus delivering Ofgem's objectives in full.

For the interim period, diurnal storage capability is essentially fixed due to construction lead times. However, we would envisage DNs being able to specify incremental diurnal storage requirements through transparent processes set out in the Offtake Code where incremental capacity is available.

We have developed an outline implementation plan involving the introduction of Option B consistent with the need to develop an appropriate commercial framework through industry consultation, to develop the business rules and to develop the associated IT systems. The timing and features of this are set out in Appendix 2.

As part of our initial thoughts on how the Option B proposal detailed in Appendix 2 might work, we have also considered the issues surrounding the commercialisation of operational flow products for use by DNs and NTS direct connect shippers. We believe that these could be developed alongside the development of the exit capacity and diurnal storage products, consistent with the delivery of IT systems necessary to support them.

As with Option 2B for NTS exit capacity, we believe that any commercial arrangements for diurnal storage and operational flows as between transporters and shippers should be covered under the Unified Network Code. However, the Offtake Code will be required to establish the aggregate quantity and how the provision of diurnal storage is managed between operators.

Business Separation

Our views on the appropriate level of NTS/DN separation are detailed in Appendix 3. In summary, we propose a set of targeted structural separation measures between NTS and Transco's retained DNs (a hybrid of Options 1 and Option 2) in place of full structural separation and/or legal separation (Option 3).

We acknowledge Ofgem's objectives to ensure that there is no risk of undue discrimination by Transmission ("NTS") in favour of retained distribution networks ("RDNs"). However, the costs of legal and full structural separation as a means of achieving this objective would be significant. These consist of both upfront and ongoing costs, which means that both NGT and consumers would bear these.

We have assessed the scope for undue discrimination by the NTS and concluded that the risk of undue discrimination occurring is very low. This is because, even if there was intent on the part of the NTS to unduly discriminate, then:

- We recognise that it would render NTS liable to enforcement action – a powerful and effective deterrent;
- In many areas, NGT would also be taking a high risk that parts of its revenue would be disallowed;
- The areas in which NTS could unduly discriminate are identifiable and very narrow;
- The proposed solutions for Offtake arrangements, diurnal storage and interruption will remove the ability of NTS to unduly discriminate in these key areas;
- It would be highly visible and transparent if the NTS were to unduly discriminate as all of NTS' processes will be auditable, with information published after the day, thereby facilitating effective challenge; and
- NGT will be held accountable in audits, industry forums and reporting requirements.

In view of the minimal scope for undue discrimination, we propose a set of targeted 'fit for purpose' separation measures that will effectively manage any residual opportunity for inadvertent undue discrimination. These include:

- **Code of conduct:** NGT proposes a Code of Conduct on the communication of information between NTS and all DNs. This Code of Conduct would apply to all NTS employees who operate at the NTS/DN interface and all support services staff and would be reinforced with guidance and briefings;
- **Targeted structural separation** – i.e. operational and information separation between NTS and retained DNs (enforced by an appropriate licence condition). Although NTS and retained DNs are already separate in many respects, we are proposing a number of targeted measures to put in place the appropriate separation between NTS and RDNs.

This approach of targeted measures between NTS and RDNs would also be consistent with Ofgem's policy in dealing with other network groups where the risks of undue discrimination are comparable, i.e. between network monopolies (for example, under BETTA).

Fundamentally, it would be both inappropriate and inefficient to impose structural solutions (legal and/or full business separation) when targeted solutions fully address the prevailing concerns - and particularly (as in this case) where legal separation and full structural separation would be costly and add no further safeguard against undue discrimination by NTS.

Our approach to NTS / RDN business separation importantly encapsulates fit for purpose targeted measures that fully deliver a high degree of protection to all DNs against any potential risk of undue discrimination by NTS. This approach protects consumers is efficient and preserves future

flexibility. It also complies with other important regulatory objectives of proportionality and consistency with other areas of regulatory practice.

I hope you find this response helpful.

Yours sincerely

By E-Mail

Chris Train