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Dear Sonia

NGT Potential Sale of Gas Distribution Network Business – Offtake Arrangements Regulatory Impact Assessment

We welcome the opportunity to comment on the options that have been discussed in Ofgem's Regulatory Impact Assessment (RIA) on the proposed Offtake arrangements at the interface between the National Transmission System (NTS) and Distribution Networks (DNs) following the sale of one or more of Distribution Networks (DNs).

As Ofgem is aware, SSE is supportive of the DN sale project. We are nonetheless disappointed with the recommendations contained in this consultation paper. In particular, we firmly believe that only those changes that are necessary and expedient to facilitate a proposed DN sale should be considered in this process. We are concerned that Ofgem's proposals for the offtake arrangements go beyond this narrow remit. In our view, the options favoured by Ofgem in this paper would involve a fundamental change to the existing regime over and above that which is required to accommodate separate ownership of one or more DN's.

In addition, we firmly believe that these reforms would inhibit supply competition and add unnecessary complexity to the regime. Complexity inevitably leads to additional cost (and risk) to market participants that will ultimately be borne by end users. Indeed, we are concerned that the introduction of unnecessary change and complexity, as proposed in this paper, could undermine the cost benefit of a proposed sale. It would also challenge the proposed timetable for a sale.

We have set out specific concerns in the attached paper. However, in summary:

1. We firmly believe that only those changes that are absolutely necessary to facilitate the possible separate ownership of one or more DN's should be considered as part of this process. We are therefore extremely concerned that many of the options that

have been considered by Ofgem in this RIA have proposed complex commercial regimes that are not justified or necessary.

2. We do not believe that there is any justification for the proposal that shippers should determine the appropriate level of NTS exit capacity at the NTS/DN offtake point. Indeed, we believe that Ofgem's cost benefit analysis of this proposal is inaccurate. If implemented we believe that this proposal would have adverse consequences for security of supply, supply competition and customers. We therefore firmly believe that established planning processes and price control incentives should be maintained.
3. Similarly, we see no justification for the introduction of a commercial, market-based arrangement in respect of diurnal storage and offtake operational flows. There is no reason to suggest that the sale of a DN would justify the introduction of what is, in effect, a commercial linepack regime. The issue to be addressed is one of operational flow rates and network parameters at the NTS/DN interface between network owners/operators. It has nothing to do with either shippers using, or customers connected to, the NTS.
4. All network to network interface issues should be transparent, set out and governed by a new interface agreement along the lines proposed by NGT as an Offtake Code and not by the Network Code which defines the contractual relationship between the network owner and the user of its network.
5. Finally, we do not support Ofgem's proposals for full legal and structural separation of NGTs transmission and distribution operations. We believe that transparent and equitable operational arrangements set out in the proposed Offtake Code along with robust non-discriminatory licence obligations would be sufficient to prevent any discrimination in favour of NGT's retained DNs.

In our view, Ofgem's present proposals would be unworkable and would challenge an efficient DN sale. As a consequence, we have set out in the attached paper an alternative approach that we believe would represent a proportionate response to the issues raised by the DN sale. We would therefore urge Ofgem to fundamentally reconsider its preferred approach and adopt this alternative proposal, or a similar framework, based on ownership of the investment decision remaining with the network operators rather than shippers.

If you would like to discuss any of the points we have made in this detailed response, please do not hesitate to give me a ring.

Yours sincerely

Rob McDonald
Director of Regulation

SSE's detailed response to Ofgem's document "NGT Potential Sale of Gas Distribution Network Business – Offtake Arrangements Regulatory Impact Assessment."

Key Issues

In the main, we agree with the list of key issues that Ofgem has identified and that must be considered when assessing the various options for offtake arrangements. We particularly agree that any new arrangements will need to ensure:

- Continued economic and efficient development and operation of the networks;
- Security of supply is maintained;
- No adverse effect on competition;
- Appropriate accountability and regulatory involvement;
- Appropriate governance of the offtake arrangements; and
- There is no undue discrimination between networks.

NTS Exit Rights Allocation

We believe that this section of the RIA is confusing. In addition, the terminology that has been used to describe the various options is inconsistent and, with the exception of option one, new terminology is introduced that is inadequately described. For example, Ofgem has introduced the terms NEC and DEC but there is no explanation of how these terms relate to SOQ and, therefore, we are unable to determine the exact extent of the changes to the current processes.

More substantially, we understood that the primary aim of the RIA was to discuss how the NTS and DN owners would determine the relevant amount of NTS exit capacity that is required at the NTS/DN offtake points in order that the DNs can meet their statutory planning obligations. This issue has arisen only because it is important to consider whether Transco's proposed Offtake Code would ensure efficient operational interaction between the NTS and DNs. Wider issues concerning the allocation of NTS exit capacity to users of the NTS network are not necessary to facilitate a DN sale.

However, Ofgem describe this section of the RIA "as the process through which rights of offtake from the NTS are allocated to users of the NTS" and paragraphs 5.6 and 5.7 describe the mechanism of an unconstrained and constrained allocation of network exit capacity by network owners to users. Ofgem imply that DNs are users of the NTS. They are not. Shippers are users of the networks. This is a fundamental principle laid down in the Gas Act. We therefore fail to understand why Ofgem is of the view that the allocation of NTS exit capacity to users includes the determination of NTS capacity to ensure that both the NTS and DNs meet their statutory duties.

There are two distinct issues here that Ofgem seem to be confusing. First, there is the issue about the terms on which users of the network (ie shippers) obtain and pay for access to both the NTS and DN. An entirely separate issue is how the DN and NTS network co-operate at an operational level to ensure that demand, in aggregate, is

satisfied. This operational issue is clearly relevant to a sale; wider issues about reforming the exit and access arrangements are not and we believe that this confusion has led Ofgem to propose a framework that is fundamentally unworkable.

Against this background, the options set out in the RIA can be separated into two high level models. Either shippers take the dominant role in determining the amount of NTS exit capacity that is to be made available, or the network owners do. We consider each in turn below.

1. Shipper Determined Model.

We believe that a shipping booking model is fundamentally flawed in concept.

From Ofgem's description, decisions concerning the level of investment required to ensure the availability of sufficient NTS exit capacity at the NTS/DN offtake point would be determined (to varying degrees) by shippers and all network planning security of supply obligations would be removed from the network owners. Therefore, rather than relying on the network owners' knowledge and oversight of the network, investment decisions would depend upon shippers' requests for capacity (and in one option would depend solely on such requests). These requests would be based on a shipper's view of the needs of their daily metered and non-daily metered sites for each DN offtake point at least three years ahead of the gas day.

In preferring this option, Ofgem has not taken into consideration the following key points.

a) Network Owner Expertise.

Given that we operate within a competitive supply market, network owners alone have a comprehensive view of the aggregate use and demand patterns of customers connected to their networks. However, if, as it has been proposed, network owners were obliged to provide and allocate the amount of capacity requested by shippers, no account would be taken of this knowledge and the operational and planning efficiencies associated with optimising a network's overall demand diversification would be lost. Ofgem has taken no account of this loss of efficiency.

b) Shippers' Ability to Accurately Forecast.

In the competitive gas supply market, a shipper does not know how much capacity it will require years ahead since the level of churn within both the domestic and I&C market is significant and customers can change supplier (and therefore shipper) at relatively short notice. Therefore, under this proposal shippers would have to speculatively book capacity based on their best guess of the size and profile of their future customer portfolio. We therefore disagree with Ofgem that this option would provide significant benefits to the economic and efficient network operation and development (Ofgem suggest a benefit of some £25.7m) on the grounds that shippers

would NOT be able to “request exactly what their customers require”.

c) Security of Supply

We also note that Ofgem has failed to make an assessment on the impact this option would have on security of supply. We suggest that if Ofgem had made this assessment it would have shown a significant “cost” since the option would ensure that no single entity (ie the relevant network owner) would have the responsibility for ensuring that the one in twenty security of supply provisions are met. Rather, an assumption has been made that collectively shippers’ requests for capacity will be sufficient to ensure that security of supply is maintained. However, no account has been taken of the fact that in order to make the necessary investments to meet security of supply standards, network owners require information relating to the future demand of customers some three years ahead of the gas day. As we have already explained, shippers will not be able to provide this information with any confidence and we therefore believe that this option poses a significant threat to security of supply.

Put bluntly, shippers’ combined estimates of their likely requirements at each exit point many years ahead are likely to be significantly less accurate than the considered forecast of the DN. The extent of shipper inaccuracy, given the inherent uncertainties would be substantial, with obvious implications for security of supply.

d) Competition in Supply

Under this proposal, Ofgem has pre-empted the outcome of the exit and interruption regime and has assumed an allocation methodology that appears to replicate the current NTS entry capacity methodology. That is, a “ticket to ride” principle with overrun charges, use-it-loose-it (UIOLI) and the development of a secondary NTS exit capacity market. In other words, Ofgem is seeking to create a market-based mechanism to allocate NTS exit capacity. However, no consideration has been given to the practicalities and cost of doing so. For example, how will a shipper be able to commit itself to the requisite amount of capacity for an unknown, future portfolio? How will a UIOLI regime work when the gas reconciliation process is not concluded for months or even years after the day? New entrant shippers/suppliers would have to rely on a liquid secondary market in order to enter the market that would be a barrier to entry but it is not clear that such a market would develop given the transaction costs. There is also a risk that outgoing or dominant shippers/suppliers with large capacity volumes would have a significant “hold” over the market.

Ofgem’s cost benefit analysis of this option has made no assessment of the impact this option would have on competition. For the reasons set out above, we firmly believe that the complex mechanism envisaged by Ofgem would introduce a significant barrier to entry within the competitive supply market. The added cost and risk of the scheme would also be passed on to customers.

e) Regulatory Oversight.

Ofgem has also suggested that a pure shipper booking model would require significantly less regulatory involvement on the grounds that fewer Ofgem and industry staff would need to be devoted to the price control process. Given our experience of the impact a similar regime has had on the NTS entry capacity arrangements (where there are comparatively few entry points) we fail to understand how Ofgem has come to this conclusion. We would argue that the equivalent regime at entry has required an increased regulatory involvement in terms of the developing, implementing and monitoring an extensive suite of price control licence obligations; a complex methodology to determine and assess whether incremental investment should be made including Ofgem's integral role in that process; a complex incentive regime; and issues associated with over and under recovery of allowed revenue.

In summary, we fundamentally disagree with Ofgem's assessment of the benefits associated with its preferred shipper booking methodology. In particular, we believe that this model would: a) fail to provide for the economic and efficient network operation and development; b) fail to provide any certainty for security of supply; c) undermine competition for gas supply; d) increase the cost of regulation; and e) impose significant implementation costs.

2. Network Owner Determined Model

An alternative to the above market based, shipper-booking methodology, is the existing process whereby network owners determine the requisite level of NTS exit capacity at the NTS/DN interface. We very firmly believe that placing the network owners at the centre of the process is essential to ensure the efficient and economic operation and development of the networks and to ensure security of supply.

Clearly, it is important to ensure that suitable arrangements are applied to both the NTS and DN owners to ensure that an efficient amount of investment is undertaken at the NTS/DN boundary. Furthermore, it would be inappropriate for one network owner to take precedent over another in determining the amount of capacity to be made available. We therefore agree with Ofgem that the aspect of NGT's proposal that ensures the NTS would, in effect, determine whether or not a DN is able to meet its statutory one in twenty planning obligation is inappropriate. If NGT's proposed approach were to be adopted, a DN would not be able to deliver its obligations. However, we believe that Ofgem's concern that NGT might discriminate in favour of its retained DNs in the provision of NTS exit capacity is perhaps overstated and could be effectively managed by a transparent planning process at the NTS/DN interface and robust non-discriminatory licence obligations.

Therefore, rather than redesigning the entire exit capacity regime (as per Ofgem's preferred option), NGT's network planning proposal could be simply adjusted to overcome the NTS-dominance issue. In order to achieve this, an approach should be adopted whereby each network owner would have a licence requirement to plan and manage an efficient, safe and economic network in accordance with the planning

standards. To aid this process, the licence obligation could include an explicit reference to co-operate with other network owners. In the event that the planning process genuinely resulted in a difference of opinion the efficient and economic level of capacity, each party would have a right to appeal to Ofgem. Furthermore, the periodic, regulatory price control process would provide each network owner with a real, commercial incentive to ensure that only an appropriate amount of capacity is provided since any over-investment would (presumably) not be “allowed” in future price control reviews. In these circumstances, the situation envisaged by Ofgem whereby a DN could in some way require the NTS to over invest would not arise. We therefore fail to understand why, in its cost benefit analysis, Ofgem has assumed that a DN is likely to be accountable for 20% over investment under option 1 when, quite clearly, the price control mechanism would, and indeed does, ensure that only an efficient level of investment is undertaken.

In our view, this approach would be sufficiently robust to manage future investment decisions at the NTS/DN interface. Furthermore, it would enable a network owner’s unique oversight of the network to be optimised to ensure that an economic and efficient level of investment would be made consistent with the security of supply obligations.

We note that Ofgem has stated that this approach would require an unacceptably onerous level of ongoing regulatory input that would increase the cost of this arrangement. We disagree and question why Ofgem has come to this conclusion since experience of the same planning and price control regime within the electricity sector provides no evidence of disproportionate regulatory oversight, cost or inappropriate levels of investment at various network interfaces. Furthermore, evidence of the NTS entry capacity regime suggests that Ofgem’s involvement in a market/shipper based model is considerably more onerous. Under the entry capacity regime, NGT does not make any permanent incremental investment without Ofgem’s implicit “consent” through the incremental entry capacity release methodology. In other words, under a shipper-based market approach (be it at entry or exit) Ofgem is/would be involved in every permanent incremental investment decision. By contrast under the proven, network planning methodology, Ofgem is/would only be involved if a genuine dispute between network owners were to arise.

This option clearly involves a minimum change to the existing arrangements and contrary to the findings of Ofgem’s cost benefit analysis, it will have the least (negative) impact on a) the economic and efficient network operation and development; b) security of supply; c) competition; and d) regulatory involvement. Clearly it would also have the least, (ie zero), implementation cost, in contrast to other options where Ofgem has suggested an implementation cost of £8.5m (although we believe this sum significantly underestimates the likely implementation costs associated with Ofgem’s preferred option). Furthermore, this is the only option that would not have a significant design and implementation timetable associated with it and could therefore be implemented within the DN sales existing timetable.

Indeed, given that Ofgem has based the GB competitive energy supply arrangements upon the principle that monopoly network owners are regulated, by means of a periodic price control to ensure the continued economic and efficient operation and development

of the networks to meet the statutory security of supply standards, it is somewhat surprising that Ofgem's RIA concludes that a model based on this principle is the least acceptable to it.

The only possible variation to the above approach which could be acceptable would involve an approach that gave the DN greater, rather than equal, influence over the amount of capacity that is made available at the NTS/DN interface (ie along the lines of option two but without the involvement of shippers). If this were to be adopted, we see no reason why an incentive mechanism any more complex than, for example, a simple exposure to x% of allowed revenue in the event that it was determined that the DN had requested "too much" NTS exit capacity. This could, for example, be broadly similar to the electricity distribution IIP scheme with symmetrical, annual rewards and penalties to the extent that the DN's capacity requests were "incorrect". However, such a scheme would raise additional risks to the DN, which would need to be reflected in the cost of capital. The scheme would also require caps/collars to mitigate the risks to the DN and network users.

We certainly see no justification for a more complex incentive model that involves assigning and determining relevant overrun charges etc between network owners and shippers as proposed by Ofgem. In any event, we do not believe that it would be possible to implement an alternative incentive mechanism to the current, price control mechanism within the proposed DN sales timetable. Therefore, any proposals to progress a change to the regime in this way should only be considered at the time of next price control review.

3. A hybrid model

Given the views expressed so far, we cannot see any benefit in Ofgem's proposed hybrid model whereby shippers and DNs between them would, somehow, determine the amount of capacity made available at the NTS/DN interface. In addition to attracting all of the disadvantages we have outlined in respect of the shipper-booking model above, it has the added disadvantage of a "shared" responsibility for meeting NTS/DN exit capacity requirements. We therefore conclude that this is the worst possible solution and consequently we have not given options three or Ofgem's proposed variant to option two any further consideration.

Diurnal Storage and Operational Flow

We see no reason why it would be necessary to implement complex, market based allocation and pricing mechanisms for both diurnal storage and operational flow parameters in order to facilitate a proposed sale of one or more DNs. This issue is already managed by NGT within the usual planning process and we therefore believe that appropriate and transparent rules along with non-discriminatory licence obligations should be sufficient to manage these arrangements. We therefore support option A, NGT's proposal, in this respect.

Indeed, it appears to us that the alternative arrangement put forward in the RIA replicates Ofgem's previous proposals for a commercial "linepack" regime, for which justification has never been proved. We firmly believe that the DN sale provides no such justification and, therefore, it would be inappropriate and unnecessary to pursue this option.

Business Separation

As Ofgem will be aware from our recent note following discussion at DISG of NGT's paper on "Structural Separation Between Transmission and Distribution", we do not agree with Ofgem's view that full legal and structural separation is required in order to prevent undue discrimination between NGT's retained DNs and those that have been sold.

Our comments on this issue were set out in our note to Ofgem dated 30 June 2004, the main text of which is attached as Appendix 1.

Governance of the Arrangements

It is clear that Transco's Network Code defines the commercial and operational contractual arrangements between Transco as the network owner and **users** of that network. In the event that a DN sale goes ahead, the DN will **not** become a user of the NTS, it will merely be a network that continues to interface with the NTS and other DNs, albeit under different ownership. It is therefore, in our view, inappropriate for the Network Code to become the relevant framework agreement for governing these network to network interface arrangements.

As a consequence, we support NGT's proposal that these arrangements should sit within the proposed Offtake Code that only network owners would be parties to and to which customers would not be able to propose modifications. Under this scenario, if a modification were to be made to the Offtake Code, it would only be implemented if all relevant parties agreed.

SSE
9 July 2004

SSE's comments on NGT separation issues sent to Ofgem on 30 June 2004

It is clearly important to ensure that appropriate protection is built into the regulatory and commercial framework in order to prevent discrimination against independent DNs by NGT in its role as SO and also as owner of the NTS.

However, we believe that this can be achieved by the combination of robust non-discriminatory licence obligations, associated compliance measures **and** appropriate and transparent arrangements associated with NTS TO/SO interfaces with DNs in the proposed industry framework agreements such as the Offtake Agreement/Code, Network Code, etc.

We believe that these provisions would provide both DN network owners and Ofgem sufficient protection against the risk of discriminatory behaviour by NGT. It would also provide Ofgem with sufficient power to investigate and take appropriate action in the event that discrimination was suspected and subsequently proven. The possibility of being found to be in breach of non-discriminatory licence obligations as a result of discriminatory or inappropriate behaviour/actions would potentially expose NGT to a fine of up to 10% of its turnover which, in our view, would be a significant deterrent to any inappropriate behaviour.

It is however clear that Ofgem's proposals for full legal, operational and management separation of the component parts of Transco would involve significant and unnecessary cost. We believe that this could challenge the cost-benefit analysis of the DN sales and we would therefore urge Ofgem to come forward with less prescriptive measures to deal with this issue. Furthermore, we do not believe that the simple statement by Ofgem that the additional costs of separation will not be recoverable is correct. In future price reviews Ofgem will, as now, have to set the price control consistent with its statutory duty to ensure that the licensee will be able to finance its functions. Disallowing such costs could result, other things being equal, in price control revenues lower than the cost of capital. This would not be consistent with Ofgem's statutory duties and hence we do not believe that separation costs can be ignored for the purpose of this regulatory impact assessment.

Indeed, we support the proposals that have been made by NGT in its recent paper and believe that full structural and legal separation of NGT's NTS and DN businesses should not be imposed unless, at some future date, it is *proven* that more prescriptive business separation requirements are necessary.

For clarity, however, we do believe that non-discriminatory licence obligations should not only apply to NGT's NTS business but that it should also apply to NGT's retained DNs and the various ring-fenced activities that have been proposed to provide services to the DNs eg metering, control room functions, Agency services, etc. Assuming that NGT will have one GT licence to cover all of its transportation activities, we therefore believe

that the non-discriminatory requirement should apply to **all** of NGT's activities and the drafting would be along the lines of "NGT shall not, and shall procure that no affiliate or related undertaking shall not, discriminate in providing transportation and other services"