

GAS DISTRIBUTION NETWORK SALE

OFGEM PRELIMINARY POSITION ON THE UNIFORM NETWORK CODE MODIFICATION PROCESS & THE CONSTITUTION OF THE GOVERNANCE ENTITY

Introduction

If Transco sells one or more of its distribution networks (DNs), a new class of industry participant will be created and the existing relationship between Transco and shippers will undergo fundamental change. An important aspect of the DN sales process is to develop a set of governance arrangements that reflect the new industry structure, including the process by which changes to the Uniform Network Code (UNC) are proposed and accepted.

The Agency & Governance Arrangements decision document sets out Ofgem's view that in the event that the proposed sales proceed, a governance entity should be established in order to administer the UNC modification process.¹ Since the publication of the decision document, the Development & Implementation Steering Group (DISG) has sought to further develop the proposed governance arrangements, including:

- ◆ the process for modifying the UNC; and
- ◆ the role and constitution of the governance entity.

This paper sets out Ofgem's current position on these two issues. Ofgem intends that these views will be incorporated into detailed proposals that will be subject to public consultation. Further information regarding the way forward is set out at the end of this document.

In issuing this position paper, it is important to make clear that there can be no expectation on the part of Transco, potential DN purchasers or any other interested parties either as to what the Authority's final decision in relation to the proposed DN sales may be, or as to the regulatory framework which may be implemented if the Authority consents to the proposal. This position paper is provided on an informal basis and should not be treated as binding on the Authority. Nothing in this position paper is to be construed as granting any rights or imposing any obligations on the Authority. The

¹ *National Grid Transco – Potential sale of gas distribution network businesses, Agency & Governance Arrangements Decision Document, Ofgem, May 2004 pg 27.*

Authority's discretion in this matter will not be fettered by any statement made in this paper.

Key issues

Ofgem considers that the new governance arrangements should be designed in accordance with the following principles:

- ◆ **Non-discrimination.** The governance arrangements should avoid any undue discrimination between parties. In order to achieve this it is important that decisions should be made by reference to predefined objectives, and that decision makers should have full access to all relevant information;
- ◆ **Transparency.** Decisions should be taken transparently. This means that information must be available to all affected parties and that discussion and analysis should be visible;
- ◆ **Inclusiveness.** There should be no exclusion of relevant information or viewpoints. Consequently, contributions should be allowed from all interested parties on key decisions;
- ◆ **Effectiveness.** Decision-making processes should balance the need for timely decision making and thorough consideration of issues; and
- ◆ **Efficiency.** Decision-making processes should not impose undue administrative costs on industry participants and should ensure that issues are resolved in a timely manner.

In preparing this position paper Ofgem has sought to give effect to each of these principles.

UNC modification process

Consistent with Transco's licence obligations, the network code modification process is currently established and operated by Transco. If a sale proceeds, it will be important to ensure that the UNC modification process prevents a single party or class of parties from dominating the modifications process.

Ofgem believes that the UNC modifications process should be based on the existing

modification rules, however, changes should be made in order to fulfil the objectives of non-discrimination, transparency, inclusiveness, effectiveness and efficiency. This will entail the establishment of a single UNC modification process administered by an independent entity (the governance entity), and the removal of certain features of the existing regime such as the 'Transco veto'. A key aspect of proposed changes is to reflect the more diverse industry structure by giving parties other than Transco a greater role in the modification process, including by making the role of the Modifications Panel more substantive role than at present.

In order to give effect to the proposed changes, it will be necessary to amend NTS and DN Gas Transporter's (GT) licences such that all GT licences contain shared common relevant objectives. Additionally, the NTS and DNs should be required to collectively establish and operate an UNC which includes UNC modification rules.²

Functions of the Modifications Panel

The functions of the Panel should include:

- ◆ determining a schedule for each proposal within minimum and maximum limits for assessment of non urgent modification proposals set out in the modification rules;
- ◆ establishing the terms of reference and the associated timetables when referring proposals for development through workstreams;
- ◆ approving invitations to tender for independent consultancies to be engaged by the governance entity (subject to a maximum annual budget approved by the governance entity's board of directors);
- ◆ where appropriate, expressing an initial view for incorporation in the Draft Modification Report;
- ◆ where appropriate, making recommendations to the Authority on whether to accept or reject a modification proposal, for incorporation into the Final Modification Report;
- ◆ reviewing draft Modification Reports, and being responsible for the publication of Modification Reports.

² This paper does not consider the matter of whether the UNC should be established by means of GT-specific short form codes, or how such short form codes should be governed.

Composition of Modification Panel

Having considered the proposals put forward at DISG meetings, Ofgem considers that the Modifications Panel should be composed as follows:

- ◆ **Voting members.** Ofgem believes that each NTS and DN GT licensee should have a voting member on the Panel, and there should be an equal number of shipper voting members. Arrangements for proxy voting would apply.
- ◆ **Non-voting members.** The status and roles of non-voting members, including their ability to express views and make recommendations, would remain as now.
- ◆ **Chair.** Ofgem considers that the Panel should be chaired by a senior member of the Governance Entity staff.
- ◆ **Independent Gas Transporters.** If, at some point in the future, Independent Gas Transporters accede to the UNC, then they should have voting rights on the Modification Panel. In this case it would be necessary to reconsider voting rights in order to ensure an appropriate distribution.

A simple majority rule would apply to Modifications Panel decisions. The chair would not normally vote, however in the case of an equally split vote, the chairperson would exercise a casting vote (unless the decision relates to a recommendation to be made to the Authority). When the chairperson exercises his/her casting vote, he/she would be required to make a decision in accordance with the UNC relevant objectives.

If there is an equally split vote in relation to a decision on a recommendation to be made to the Authority, then the Panel would not make a recommendation (and accordingly would forfeit the right to appeal the Authority's decision).

All final modification reports should record the proportion of votes cast for and against the proposal along with the main reasons why the proposal better facilitates (or does not better facilitate) the relevant objectives. If the Panel's decision was not unanimous among all voting members an outline of the balance of opinions should be given.

Ofgem believes that this approach will provide an appropriate balance between the various principles set out in the key issues section above. Ofgem acknowledges that the proposed approach gives a key role to the chair of the Panel, and reinforces the

importance of creating an independent governance entity. Ofgem believes that the presence of an independent chair with a casting vote is preferable because it promotes effectiveness and reduces the risk of unnecessary delays to the modifications process arising as a result of deadlock. Further, given that dissenting members' views must be recorded in the Final Modification Report, the Authority will have access to all information when making its decision.

Ofgem notes that it may be necessary to review the functions of the Panel depending on the outcome of the Department of Trade and Industry's consideration of the appeals process established by the Energy Act 2004. In particular, it may be necessary to review the process by which recommendations are made to the Authority.

Amendments to modification proposals

Ofgem agrees with the view expressed by DISG members that the modification process should ensure equivalent treatment of GT and shipper modification proposals. Consequently, Ofgem supports the notion that the party who puts forward the modification proposal (the proposer) should 'own' their proposal.

During the development phase, proposers would be permitted to adopt refinements to their original proposal, prior to the proposal being sent out for consultation. This would substitute for the original proposal. The development phase may prompt others to put forward alternatives, which may not be acceptable to the original proposer. In such cases these parties could put forward new separate modification proposals.

Content of modification reports

In addition to the current format of modification reports, Ofgem believes that there should be a section in each modification report which sets out the view of gas transporters on the potential impact of the modification proposal in terms of:

- ◆ security of supply;
- ◆ system operation; and
- ◆ industry fragmentation.

UNC objectives

Ofgem concurs with the view agreed by the majority of DISG members, which is that the network code relevant objectives as set out in Amended Standard Condition 9 should be retained. These include a competitiveness of markets objective, an efficiency objective, and a discharge of licence obligations objective.

In addition, a further common objective should be introduced into each NTS and DN GT licence, which relates to the continued co-ordinated efficient and economic operation of the national system as a whole. NTS and DN GT licence holders would be required to meet that further common objective by acceding to and participating in the UNC.

Constitution of the governance entity

Transco currently carries out the administrative processes associated with modifications to the Network Code. Ofgem believes that in the event of a DN sale, it will no longer be appropriate for responsibility for these processes to reside with Transco alone. As stated in its Agency & Governance decision document, Ofgem considers that the creation of a governance entity will increase transparency and visibility as all proposed modifications will be administered in a consistent manner, regardless of which network operator initiates it.

Consequently, Ofgem believes that it is appropriate to add a new condition to the GT licences of NTS and DN operators which has the effect of requiring NTS and DN GTs to establish and operate a governance entity. This could be achieved, for instance, by licence conditions that require GTs to:

- ◆ make arrangements for the co-ordinated, efficient, and non-discriminatory administration of modification proposals to the UNC; and/or
- ◆ establish and support a governance entity for such purpose; and/or
- ◆ be party to an agreement with other GTs for such purpose.

When discussing the constitution of the governance entity, a number of DISG members have expressed the view that if the rules for the modification process are robust and transparent then concerns surrounding the independence of the governance entity are reduced. Conversely, some DISG members believe that the UNC modification process

is not simply an administrative process and there is the potential for undue discrimination in the production of legal text and modification reports. In developing its position on the constitution of the governance entity, Ofgem has considered these views and sought to find an appropriate balance.

Functions of the governance entity

The primary function of the governance entity would be to administer the UNC modification process.³ The governance entity's role would include:

- ◆ preparing draft and final Modification Reports;
- ◆ arranging and chairing Modification Panel meetings;
- ◆ managing UNC development workstreams;
- ◆ co-ordinating input from GT and shipper subject-matter experts;
- ◆ where authorised by its board of directors, engaging consultants to contribute towards the development of modification proposals; and
- ◆ drafting the legal text associated with proposed amendments to the UNC.

It would be a matter for NTS and DN GT licensees to decide how to carry out these functions in a manner which is consistent with their licence obligations.

One option for the staffing of the governance entity is that NTS and DN GTs could elect to contract out the entire function on a fixed term contract (for example, a 2 year contract). This approach has advantages in terms of cost containment and defined service levels, and also ensures that the staff belong to an independent organisation rather than being GT staff. Consequently, this approach could help NTS and DN GTs to demonstrate compliance with their licence obligation to make arrangements for the co-ordinated, efficient, and non-discriminatory administration of modification proposals to the UNC. Ofgem notes that such a tender is unlikely to be feasible within the current price control period.

³ Ofgem also believes that the governance entity should administer changes to network operators' charging methodologies. Ofgem's position on charging methodologies is addressed in a separate paper.

Funding & governance of the governance entity

Ofgem agrees that, for the remainder of the current price control, it is appropriate that NTS and DNs discharge their joint obligation to maintain the UNC by establishing and funding a governance entity by establishing a Joint Office of Gas Transporters.

Ofgem believes that Transco's proposal to develop a 'Joint Office Agreement', which all NTS and DN GTs must be party to, is an appropriate vehicle for establishing the governance entity. Among other things, the governance entity's governance arrangements should entrench its duty to act impartially in the exercise of its functions. The Joint Office should be funded by subscription fees in line with current DN and NTS price controls.

The governance entity could have the ability to engage independent consultants to contribute towards the development of modification proposals. In order to ensure that projects for which consultants are required are selected in an impartial manner, the Modifications Panel could approve the governance entity's invitations to tender. In order to contain consultancy costs, the governance entity's board could set the consultancy budget and any expenditure above this limit could require board approval.

The delivery of the appropriate level of service is also critical to the effective administration of the arrangements and so a detailed specification of requirements may be appropriate.

Business separation requirements

A key feature of the proposed governance arrangements is that the governance entity is able to exercise its functions independently and without undue regard to the interests of any particular party. Consequently, Ofgem believes that the Joint Office should be subject to structural separation, including information separation, separate staff and separate offices (or offices with separate security access).

Way forward

Ofgem's position on the UNC modification process and the constitution of the governance entity is the product of careful consideration of feedback generated through extensive discussions in the DISG. The next stage in the DN sales process is to

undertake public consultation on the detailed changes required to give effect to these and other reforms. To this end:

- ◆ Ofgem intends to issue an informal consultation document on potential modifications to Transco's GT licence and the form of the new DNs' GT licences, followed by a s23 consultation; and
- ◆ Transco is developing modification proposals associated with changes to the Network Code.

If the Authority gives conditional consent to Transco's proposed sale of one or more DNs at its November meeting, a final decision on these issues will be made after the consultation process is complete.