

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

Offtake arrangements

Conclusions document on framework

August 2004

Summary

In May 2003, Transco publicly announced that it would consider the sale of one or more of its DNs if it were to maximise shareholder value. Any such sale would require the consent of the Authority, the Health and Safety Executive (HSE) and the Secretary of State.

In June 2004, following extensive consultation in industry workgroups, Ofgem issued a Regulatory Impact Assessment (the Offtake RIA) for consultation on offtake arrangements from the National Transmission System (NTS) if National Grid Transco (Transco) were to sell one or more of its gas Distribution Networks (DNs)¹. The areas consulted upon in this document included both the offtake arrangements and business separation, with a quantitative and qualitative assessment of each area.

This conclusion document outlines the views received from respondents on the options outlined in the Offtake RIA and presents the Gas and Electricity Markets Authority's (the Authority's) conclusions.

In issuing this document and describing the proposed regulatory process to be followed, it is important to make clear that there can be no expectation on the part of National Grid Transco, Transco plc, potential DN purchasers, shippers or any other interested parties either as to what the Authority's final decision in relation to the proposed transaction may be, or as to the regulatory framework which may be implemented if the Authority consents to the proposed transaction. The information contained in this document is not binding on the Authority. Nothing in this document is to be construed as granting any rights or imposing any obligations on the Authority. The Authority's discretion in this matter will not be fettered by any statements made in this document and all references to the proposed timetable or decisions by the Authority are qualified by this statement.

Objectives

The Authority's primary objective, as set out in the Gas Act 1986, as amended, is to protect the interests of customers in relation to gas conveyed through pipes, wherever appropriate, by promoting effective competition between persons engaged in, or in commercial activities connected with, the shipping, transportation or supply of gas.

Therefore, when deciding whether to consent to the proposed disposal of one or more DNs, the Authority will consider, among other things, whether the interests of present and future customers are protected.

It is also essential that the post-sale industry structure is:

- ◆ consistent with the Authority's general duties; and
- ◆ permits each network owner to fulfil its own statutory and licence obligations.

Key issues

The key issues considered by Ofgem within the Offtake RIA were:

- ◆ **Undue discrimination between networks.** Ofgem considered that the offtake arrangements should limit the opportunity for undue discrimination by Transco as the owner of both the NTS as well as the Retained gas Distribution Networks (RDNs). Undue discrimination could, for example and without limitation, take the form of Transco NTS providing favourable commercial terms to an RDN or number of RDNs over the Independent Distribution Networks (IDNs), which could lead to inefficiencies in both the level and allocation of costs borne by end customers across the network.
- ◆ **Undue discrimination between NTS offtake points.** The offtake arrangements should deliver a framework in which the risk of Transco NTS unduly discriminating between DNs and parties who hold agreements with Transco NTS at other NTS exit points is minimised. Ofgem therefore considered that the arrangements should be developed in a way that delivers consistency of treatment between the DNs and holders of Network Exit Agreements (NExAs), Connected System Agreements (including those applicable to interconnectors) and Storage Connection Agreements (SCAs). In addition, Ofgem considered that the arrangements should minimise the risk that Transco NTS is able to commercially favour RDNs over other connected users (such as storage sites and/or large connectees), as this would have the potential to create market distortions and increase costs to end customers (as outlined above).

¹ Note that by DNs, we mean both those networks sold through the DN sales process (the Independent gas Distribution Networks) and those retained by Transco (the Retained gas Distribution Networks).

- ◆ **Economic and efficient development and operation.** Consistent with the statutory duty on gas transporters, Ofgem considered that the offtake arrangements should ensure the economic and efficient development of the transmission system.
- ◆ **Security of Supply.** Ofgem considered security of supply to be an important issue in the development of the offtake arrangements. The form and content of the arrangements should be developed in such a way that ensures that DNs (i.e. both IDNs and RDNs) and the NTS are operated in a way consistent with the ongoing preservation of security of supply.
- ◆ **Impact on competition.** Ofgem considered that the offtake arrangements should be developed in such a way that protects, and where possible promotes, competition in wholesale markets and retail markets.
- ◆ **Accountability and regulatory involvement.** The offtake arrangements should specify the commercial and operational arrangements that apply at the NTS/DN interface in a transparent manner. A clear set of offtake arrangements would therefore reduce the potential for disputes during the capacity allocation process, and consequently the level of ongoing regulatory involvement required.
- ◆ **Governance of the offtake arrangements.** It is important that the governance arrangements allow the offtake arrangements to evolve in a manner which is efficient and not unduly discriminatory as the wholesale and retail gas markets continue to develop.

Initial RIA

The Offtake RIA outlined options relating to three areas of offtake arrangements. These were:

- ◆ allocation of NTS exit capacity;
- ◆ analysis of options for diurnal storage and operational flows; and
- ◆ analysis of options for business separation.

Allocation of NTS exit capacity

In the Offtake RIA, Ofgem outlined four options for the allocation of NTS exit capacity:

- ◆ **Option 1 - Transco's initial proposal.** This option was proposed by Transco on the basis that it most closely reflects existing arrangements within Transco. It formalised current internal arrangements, and gave the NTS a central role in the determination of NTS exit capacity levels;
- ◆ **Option 2 – NTS connects booking model.** This option gave the central role in the arrangements to the DNs and NTS direct connects, with the NTS obligated to provide the level of exit capacity requested. This option had two variants, which differed in terms of payment flows between participants;
- ◆ **Option 3 - Shipper booking model (with DN “top-up”).** This was a hybrid model, in which exit capacity requests were made by shippers on behalf of customers on a DN, with DNs making additional capacity requests to ensure offtake capacity is consistent with the 1 in 20 obligation; and
- ◆ **Option 4 - Shipper booking model (without DN “top-up”).** This option gave shippers on behalf of customers the responsibility for booking NTS exit capacity. In addition, the 1 in 20 obligation was removed from DNs in this option, thus allowing the market to determine the appropriate level of security.

Ofgem's initial assessment of each of these options is summarised in Table 1 below. In terms of the quantitative analysis, Ofgem chose Option 1 as the base case. As such, Options 2, 3 and 4 are assessed in quantitative terms as a variation on Option 1.

Table 1 Summary of evaluation of options for the allocation of NTS exit capacity²

Issue	Option 2	Option 3	Option 4
No undue discrimination between networks	✓ ✓	✓ ✓	✓ ✓
Economic and efficient network operation and development	✓ ✓ ✓	✓ ✓ ✓	✓ ✓ ✓
Security of supply	-	-	-
Effect on competition	✓ ✓	✓ ✓	✓ ✓
Accountability			
◆ Less regulatory involvement	✓ ✓	✓ ✓	✓ ✓
◆ Implementation cost	✗	✗ ✗	✗ ✗
Net increase in potential benefit relative to Option 1	£27.1m	£18.6m	£33.2m

Analysis of options for diurnal storage and operational flows

The Offtake RIA also outlined options for the inclusion of diurnal storage and operational flows in the offtake arrangements. These were:

- ◆ **Option A – “centrally planned” approach.** Under this option, diurnal storage and operational flows would be allocated in accordance with rules that are based on Transco’s existing internal procedures (which would be formalised); and
- ◆ **Option B – “market based” approach.** An alternative approach would be to define diurnal storage and operational flows as capacity products distinct from NTS exit capacity, and enable market participants to purchase these products on a non-discriminatory basis at NTS offtake points.

Ofgem’s initial assessment of Option B (compared to Option A) is summarised in Table 2 below. In terms of the quantitative analysis, Ofgem chose Option A as the base case. As such, Option B is assessed in quantitative terms as a variation on Option A.

² The rating system assesses each category on a sliding scale from “much better” (✓ ✓ ✓) to “much worse” (✗ ✗ ✗), with a middle assessment of “no change” (-).

Table 2: Summary of evaluation of diurnal storage and operational flow options

Issue	Option B
No undue discrimination between networks	✓ ✓
Economic and efficient network operation and development	✓ ✓
Security of supply	-
Effect on competition	✓ ✓
Accountability	
◆ Less regulatory involvement	✓ ✓
◆ Implementation cost	✘
Net increase in potential benefit relative to Option A	£11.7m

Analysis of options for business separation

In addition, the RIA set out three options for business separation:

- ◆ **Option 1 - Transco’s proposal.** This option would permit Transco to retain its existing level of business separation between NTS and RDNs, with further safeguards being provided through the adoption of targeted rules and licence conditions.
- ◆ **Option 2 - Structural separation.** This option would put in place structural separation between the NTS and the group of RDNs, including information separation, operational separation and physical separation.
- ◆ **Option 3 - Legal and structural separation.** In addition to the requirements of Option 2, the NTS and the group of RDNs would be in two separate legal entities with at least two separate gas transporters licences.

For the avoidance of doubt, the consideration of RDN/RDN separation was outside the scope of the offtake RIA.

Ofgem’s summary of the benefits of each form of business separation, as outlined in the Offtake RIA are described in Table 3 below.

Table 3 Benefits of different forms of business separation

Form of separation	Benefits
Information separation	<ul style="list-style-type: none">- minimises the potential commercial advantages that the NTS can confer on any RDN by placing limitations on information sharing
Operational separation	<ul style="list-style-type: none">- removes NTS and RDN staff from situations where they may act in a discriminatory manner- establishes a transparent interface between the businesses by placing limitations on the sharing of staff between NTS and RDN businesses
Physical separation	<ul style="list-style-type: none">- limits opportunities for NTS and RDN staff to develop close working relationships because staff may not work together in the same offices- ensures that all NTS and RDN staff are more aware of their obligation to behave in a manner that is not unduly discriminatory
Legal separation	<ul style="list-style-type: none">- reinforces the delineation between businesses- creates an enhanced requirement for separate accounts with a clear audit trail- promotes robust corporate governance- ensures that licence conditions apply equally to all DNs in practice.

The Offtake RIA stated that the costs associated with structural separation identified in relation to Option 2 would apply equally in relation to Option 3. The document stated that Transco had contended that a number of additional costs would be incurred should legal separation be required. In particular, Transco argued that enforced legal separation of RDNs may have adverse effects on the cost and other terms of its existing and future borrowings which would ultimately be borne by customers. Transco also argued that legal separation will lead it to incur other costs associated with (among other things) transferring property and staff to the new entity, financial reporting, regulatory compliance and information systems.

Ofgem's initial view

Based on the analysis described in the Offtake RIA, Ofgem's initial view was that Option 4 was the most appropriate option in terms of the allocation of NTS exit capacity, although given the extent of change required, Option 2 represented an acceptable short term option – so long as shippers are able to request their NTS exit requirements directly from the NTS should they so wish.

Ofgem's initial view was that Option B was the preferred way of designing offtake arrangements for diurnal storage and operational flows. As outlined in the cost benefit analysis presented in the RIA, this option had clear qualitative and quantitative advantages over Option A.

In terms of business separation, Ofgem's initial view was that Option 3 was preferable. Ofgem was not persuaded by Transco's initial proposals for separation and instead considered that full legal and structural separation would be required between the NTS and RDNs.

Respondents' views

An overview of the fifteen respondents' views to the RIA consultation is set out in Chapter 4. In summary:

- ◆ most respondents favoured a form of Option 2 for the allocation of NTS exit capacity, with reasons stated for this including that this Option would not involve the extent of change implied by Options 3 and 4, would reduce the risk of undue discrimination by Transco and preserve security of supply;
- ◆ eleven respondents believed that Option A was the most appropriate alternative for diurnal storage and operational flows, with a number of respondents stating that developing a complex market mechanism for diurnal storage would be costly, and deliver insufficient benefits;
- ◆ the majority of respondents favoured full structural and legal separation of the NTS from the RDNs (Option 3), stating that this would be the best way of reducing the risk of undue discrimination by Transco in the arrangements; and
- ◆ respondents provided fewer comments on the most appropriate form of governance for the offtake arrangements. Of those respondents that did offer an opinion, four felt that the arrangements should be placed in a separate operator-to-operator Offtake Code, and three believed that they should be governed by the Network Code.

The Authority's conclusions

Following careful consideration of respondents' views in response to the Offtake RIA, Ofgem prepared a report and recommendation (together with supporting documents) on the way forward regarding this matter for consideration and decision by the Authority.

This was considered at a duly convened meeting of the Authority where the Authority endorsed Ofgem's recommendations, as described below:

- ◆ **NTS exit capacity.** The Authority considers that, of the different options outlined for the allocation of NTS exit capacity, Option 2 is the most appropriate for implementation as part of the DN sales process, if it considers DN sales should proceed. While Option 2 has considerable advantages over Option 1, we remain concerned that users that are connected to the DNs will not have an opportunity to signal directly to the NTS the value that they place on NTS exit capacity.

There are several advantages of the Option 2 approach including the promotion of competition and the more economic and efficient development of network businesses - that will ultimately lead to lower costs for customers - but it is recognised that, if the costs of introducing these reforms were prohibitively high relative to the benefits, then it would not be in customers' interests to pursue these issues further. It is important that these issues are kept under review following any disposal of one or more DNs and that the governance framework should allow the offtake arrangements to evolve, where appropriate, towards a more market based approach to determining network capacity at the DN level. However, recognising respondents' views on the challenges associated with this approach, Ofgem considers that Transco should adopt Option 2 in the event that the Authority permits the sale of one or more of Transco's DNs.

- ◆ **Diurnal storage and operational flows.** The Authority considers that Option A would not be acceptable for adoption as part of the DN sales process (due to the significant risk of undue discrimination by the NTS between NTS connectees). We therefore consider it appropriate to develop a commercial "hybrid" approach (Option A*), with diurnal storage being defined as a product that is allocated between the NTS and NTS connectees only (i.e. to DNs and NTS direct connects). Ofgem recognises that this was not consulted upon as part of the RIA process and is therefore proposing to consult on these issues through the workgroups over the coming four weeks. Ofgem will issue a position paper to the workgroups (also published on our website) to inform interested parties of our conclusions on these issues. It is important to note, therefore, that Ofgem encourages all interested parties to attend the workgroup meetings, so as to contribute fully to the development of the arrangements that will be included in the position paper, and the Final RIA.

- ◆ **Business separation.** The original RIA outlined three distinct options for the level of required separation between Transco's NTS and RDN businesses. The Authority has considered the responses received to the RIA on this subject, and is minded to require Transco to undertake a combination of targeted structural separation and legal separation of NTS and RDN businesses. We consider that this conclusion is a proportionate response to the issue, reducing the risk that Transco NTS would be able to act in an unduly discriminatory manner, whilst not requiring full structural separation. The conclusion is conditional on ensuring that a number of detailed implementation issues can be resolved satisfactorily. It is important to note that business separation in isolation will not mitigate against all potential risk of undue discrimination in the offtake arrangements. Business separation should therefore be considered as part of a suite of measures designed to safeguard participants from unduly discriminatory behaviour.

For the avoidance of doubt, the consideration of RDN/RDN separation was outside the scope of the offtake RIA.

- ◆ **Governance.** Given the Authority's conclusion to adopt an Option 2 approach to the offtake arrangements, we consider that further consideration is necessary of the appropriate governance arrangements for offtake. Ofgem considers that all interested parties should have the opportunity to participate in the governance arrangements.

Ofgem will be considering these issues further through the workgroup meetings. Ofgem therefore encourages all interested parties to attend these meetings, in order to contribute fully to the development of the arrangements that will be included in the Final RIA.

Having made these recommendations, the Authority instructed Ofgem to proceed on its behalf. It is important to note that this is one of a series of indicative decisions reached by the Authority before its November meeting at which it expects to definitively decide whether or not it is willing to consent to the proposed sale of one or more of Transco's DNs.

Way forward

In combination with the conclusion on the Interruptions RIA (published at the same time as this document), this document is a key step in developing the regulatory, commercial and operational framework to support a divested industry structure.

Further work is necessary to ensure that the offtake arrangements are specified in sufficient detail, and as such the conclusions described in this document are conditional upon satisfactory solutions to these issues being developed through the workgroup process.

Ofgem will now proceed to develop a Final RIA, which will consolidate the conclusions outlined in the four conclusion documents. This document, to be issued at the end of September 2004, will compare the status quo (i.e. a no sale scenario) to a fully developed post DN Sales environment (i.e. a sale scenario). The Authority will invite respondents' views to this Final RIA. These views will form part of the Authority's consideration when taking its decision in November on whether DN Sales should proceed. The Authority's decision will be based on an assessment of whether the proposed sale of DN assets will protect the interests of customers. As previously noted, therefore, nothing in this document fetters the Authority's discretion in considering whether to consent to a disposal of DN assets in November 2004³.

³ Note that, as described earlier in this summary, the information provided in this document is done so on an informal basis and should not be treated as binding on the Authority.

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1. Introduction

Purpose of document

- 1.1. In June 2004 Ofgem consulted upon a Regulatory Impact Assessment (RIA) on arrangements for offtake of gas from the National Transmission System (NTS) that would be required were National Grid Transco (Transco) to sell one or more of its gas Distribution Networks (DNs). This document (the Offtake RIA) was released in June 2004 following extensive workgroup discussions on these issues. Later the same month, Ofgem also consulted upon an RIA on the interruptions arrangements (the Interruptions RIA)⁴.
- 1.2. These RIAs were intended to contribute to the development of a possible operational, commercial and regulatory framework that could support a divested industry structure. This framework will form the basis of an alternative to the present Transco owned and operated transmission and distribution arrangements.
- 1.3. The purpose of this document is to outline the views received from respondents on the options included in the Offtake RIA and to set out the Gas and Electricity Market Authority's (the Authority's) conclusions.
- 1.4. The conclusions outlined in this document will contribute to a broader RIA that will be issued when the Authority considers whether or not to give its consent to the proposed disposal of one or more DN. This document, to be issued at the end of September 2004, will compare the status quo (i.e. a no sale scenario) to a fully developed post DN Sales environment (i.e. a sale scenario). The Authority will invite respondents' views to this Final RIA. These views will form part of the Authority's consideration when taking its decision in November on whether DN Sales should proceed. The Authority's decision will be based on an assessment of whether the proposed sale of DNs will protect the interests of customers. As previously noted, therefore, nothing in this document fetters the Authority's discretion in making that decision in November.

⁴ *National Grid Transco – Potential sale of gas distribution network businesses, Interruptions Arrangements* Ofgem, June 2004.
NGT – Potential sale of network distribution businesses
Office of Gas and Electricity Markets

- 1.5. In issuing this document and describing the proposed regulatory process to be followed, it is important to make clear that there can be no expectation on the part of National Grid Transco, Transco plc, potential DN purchasers, shippers or any other interested parties either as to what the Authority's final decision in relation to the proposed transaction may be, or as to the regulatory framework which may be implemented if the Authority consents to the proposed transaction. The information contained in this document is not binding on the Authority. Nothing in this document is to be construed as granting any rights or imposing any obligations on the Authority. The Authority's discretion in this matter will not be fettered by any statements made in this document and all references to the proposed timetable or decisions by Authority are qualified by this statement.

Background

- 1.6. In May 2003, Transco publicly announced that it would consider the sale of one or more of its DNs if it were to maximise shareholder value. Any such sale would require the consent of the Authority, the Health and Safety Executive (HSE) and the Secretary of State for Trade and Industry.
- 1.7. In July 2003, Ofgem issued a consultation document on the regulatory, commercial and operational changes that would be required to facilitate the sale of one or more DN.⁵ This document highlighted a number of "gateways" that needed to be achieved before approval of the transaction could be considered. One such gateway related to the need for exit capacity reform. Following this consultation, Ofgem issued a Next Steps document in December 2003 setting out responses to the July consultation, Ofgem's current views and a proposed way forward for considering Transco's proposals including the establishment of workgroups to take forward the development of a commercial and regulatory framework.⁶

⁵ *National Grid Transco – potential sale of network distribution businesses, A Consultation Document.* Ofgem, July 2003.

⁶ *National Grid Transco – potential sale of network distribution businesses, Next Steps Ofgem,* December 2003.

Workgroup processes

- 1.8. Since the release of the December document, Ofgem has established several workgroups including a Development and Implementation Steering Group (DISG), a Commercial Interfaces Workgroup (CIWG), a Regulatory Architecture Workgroup (RAWG) and an Agency Workgroup (AWG) to continue the proposed DN sales consultation process.
- 1.9. These workgroups have met regularly since January 2004. The workgroups have been successful in providing industry participants with an opportunity to contribute to the development of a commercial and regulatory framework that would enable the implementation of Transco's proposals to sell one or more of its DNs should Transco obtain the necessary consents.
- 1.10. Among other things, the workgroups have discussed the commercial and regulatory arrangements that may be necessary at the NTS/DN interface to address different ownership of distribution networks, including:
- ◆ the arrangements for the offtake of gas from the NTS by the DNs (both Transco's Retained gas Distribution Networks and the Independent gas Distribution Networks) and other loads connected directly to the NTS;
 - ◆ the arrangements for diurnal storage and operational flows; and
 - ◆ the degree of separation required between Transco's NTS business and its retained distribution network (RDN) businesses.
- 1.11. Workgroup discussions have highlighted the importance of these issues to the development of the possible commercial and regulatory framework. Consequently, Ofgem has formed the view that it would be appropriate and consistent with its obligations under the Utilities Act 2000⁷ to issue an RIA that considers the high level options for resolving these matters.
- 1.12. In April 2004, Ofgem released two RIAs relating to the potential sale of one or more DNs. These assessed different options for both agency and governance arrangements, and the appropriate allocation of roles and responsibilities between the NTS, the RDNs and the IDNs, following the sale of one or more

⁷ This obligation is contained in Section 5A of the Utilities Act 2000, as amended by the Sustainable Energy Act 2002.

DNs. In May 2004, following a period of consultation, Ofgem released conclusion documents in respect of both of these issues⁸. The options, and recommendations outlined in this RIA have therefore been developed specifically to be consistent with the conclusions reached as outlined in the two conclusion documents.

Interaction with Interruptions RIA conclusions document

1.13. The issues discussed within the Offtake RIA are intrinsically linked to those covered by the Interruptions RIA. Furthermore, we note that reform of exit capacity arrangements is a gateway requirement for DN sales. As such, Ofgem has considered the responses received to both consultations in parallel and issued its conclusions concerning both the Offtake RIA and the Interruptions RIA on the same day. We therefore recommend that this document is read in combination with the Interruptions RIA conclusions document.

Structure of the document

1.14. The document is structured as follows:

- ◆ Chapter 2 sets out the objectives that need to be considered in determining an appropriate set of offtake arrangements;
- ◆ Chapter 3 sets out the key issues considered in the assessment and summarises the options for the offtake arrangements contained in the RIA;
- ◆ Chapter 4 describes the views received from respondents to the consultation on the Offtake RIA;
- ◆ Chapter 5 sets out the Authority's conclusions; and
- ◆ Chapter 6 outlines a way forward.

⁸ *National Grid Transco – Potential sale of gas distribution network businesses, Allocation of roles and responsibilities between transmission and distribution networks* Ofgem, May 2004 and *National Grid Transco – Potential sale of gas distribution network businesses, Agency and Governance Arrangements* Ofgem, May 2004.

Way forward

- 1.15. This document is an important step in developing the regulatory, commercial and operational framework to support a divested industry structure. However, further work is required to ensure that the offtake arrangements are specified in sufficient detail. Subsequent, more detailed, proposals will be subject to further consultation.
- 1.16. The workgroup process will be taken forward to develop the detail of the Authority's decision. It is important to note, therefore, that Ofgem encourages all interested parties to attend workgroup meetings so as to contribute fully to the development of these arrangements. These proposals will then be developed through a combination of Network Code modifications, Transco pricing consultations and proposed amendments to Transco's Gas Transporter licence.
- 1.17. Ofgem will now develop its final RIA which will consolidate the outcomes of the four conclusions documents published to date. It will also provide an overall cost benefit analysis relative to the status quo. This final RIA will be released in September 2004. In November 2004 the Authority will consider whether to consent to the disposal of the DN assets⁹.
- 1.18. If you wish to discuss any aspect of this paper, Mark Feather (telephone 020 7901 7437) or Jessica Hunt (telephone 020 7901 7431) would be pleased to help.

⁹ As described more fully earlier in this Chapter, the Authority's decision in November is not fettered in any way by this document.

2. Objectives

2.1. This Chapter sets out the regulatory background against which the Authority will decide whether or not to consent to the DN sales process. It additionally sets out Ofgem's statutory duties and policy requirements with respect to determining options for the form and content of the offtake arrangements, including business separation.

Regulatory approval process

2.2. In order to dispose of a DN asset, Transco will require the consent of the Authority in accordance with amended standard condition 29 of its GT licence.¹⁰ In deciding whether to give consent, the Authority must act in accordance with its statutory objectives and duties as set out in the Gas Act 1986 (the Gas Act) as well as other public law duties.

2.3. The principal objective, set out in Section 4AA of the Gas Act, provides that the Authority is '...to protect the interests of consumers in relation to gas conveyed through pipes, wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities connected with, the shipping, transportation or supply of gas...'. In addition, the Gas Act places a number of other key duties on the Authority, including without limitation:

- ◆ the need to secure that, so far as it is economical to meet them, all reasonable demands in Great Britain for gas conveyed through pipes are met (Section 4AA(2)(a) of the Gas Act);
- ◆ the need to promote efficiency and economy on the part of licence holders or otherwise exempted to carry on any activity and the efficient use of gas conveyed through pipes (Section 4AA(5)(a)); and
- ◆ the need to secure a diverse and viable long-term energy supply (Section 4AA(5)(c)).

¹⁰ This condition also provides the Secretary of State with a power of veto over any proposal on the part of Transco to dispose of a transportation asset to the extent that it comprises a significant part of the gas conveyance system in Great Britain.

- 2.4. Having regard to its statutory objectives and duties, when deciding whether or not to consent to the disposal of one or more DNs, the Authority will assess, on the basis of the evidence available, whether present and future customers' interests are protected.

Regulatory objectives

- 2.5. Ofgem considered that both the principal objective and the general duties have direct relevance to the development of the form and content of the offtake arrangements in a divested industry structure. In addition to meeting the Authority's statutory duties, the post-sale industry structure must establish a relationship between the NTS, the RDNs and the IDNs that permits each network owner to fulfil its own statutory and licence obligations.
- 2.6. These include, without limitation:
- ◆ the duty of each GT to develop and maintain an efficient and economical pipeline system (Section 9(1)(a) of the Gas Act);
 - ◆ the duty of each GT to facilitate competition in the supply of gas (Section 9(1)(A)); and
 - ◆ the duty of each GT to avoid any undue preference or undue discrimination in the terms on which it undertakes to convey gas (Section 9(2)(b).
- 2.7. Further, as set out in standard condition 4D of the GT licence¹¹, each GT has an obligation to ensure that it conducts its transportation business in a manner best calculated to secure that neither it nor its affiliates and related undertakings, nor any gas shipper or supplier obtains any unfair commercial advantage, including, in particular, any advantage from a preferential or discriminatory arrangement.
- 2.8. A further licence condition that is relevant to this RIA is the requirement for the GT to charge on a cost reflective basis. This is outlined in paragraph (5) (a) of standard licence condition 4A of the GT licence¹², which states that the GT must

¹¹ This is amended standard condition 4D in Transco's licence.

¹² This is amended standard condition 4D in Transco's licence.

use a charging methodology that reflects the costs incurred by the licensee in its transportation business.

- 2.9. In addition, the post-sale industry structure must be consistent with European law.
- 2.10. Finally, Special Condition 27 of Transco's GT licence requires Transco to operate the NTS in an efficient, economic and co-ordinated manner. Ofgem considered this licence condition to be of direct relevance to the development of the offtake arrangements.
- 2.11. In developing the Offtake RIA, Ofgem carefully considered its obligations and duties, as well as other issues raised as being relevant through the consultation process. In addition, Ofgem considered the experience of the electricity industry. In electricity, there is a relatively fragmented industry structure which supports multiple distribution network operators. When it drew on the electricity experience, Ofgem kept in mind that the starting position in gas and electricity varies considerably and therefore comparisons may not always be appropriate.

3. Summary of the Offtake RIA

3.1. This chapter summarises the key issues addressed in the Offtake RIA and the options for the offtake arrangements including business separation. It also sets out Ofgem's initial recommendation, as outlined in the Offtake RIA, with respect to the options for NTS exit capacity, flexibility in offtake from the NTS, business separation and governance. The chapter outlines in turn:

- ◆ key issues for consideration;
- ◆ options for offtake arrangements; and
- ◆ Ofgem's initial analysis of the different options.

Key issues for consideration

3.2. The Offtake RIA described a number of key issues that need to be addressed when determining the appropriate form and content of the offtake arrangements in the event of a potential DN sale. These six issues are set out below:

- ◆ Preventing undue discrimination;
- ◆ Economic and efficient network development;
- ◆ Security of Supply;
- ◆ Effect on competition;
- ◆ Accountability and regulatory involvement; and
- ◆ Governance arrangements.

Preventing undue discrimination

3.3. Ofgem considered the prevention of undue discrimination to be one of the most important considerations in selecting the most appropriate option for the offtake arrangements. This is because unduly discriminatory decision making - over both the long term and short term - could lead to inefficiencies in both the level and allocation of cost borne by end customers across the network. Undue discrimination may also potentially result in an uneven impact across regions

(given that cost distortions caused by undue discrimination would affect price control determinations). Furthermore, there may be other implications of undue discrimination, including distortions to investment decisions resulting in long-term costs to customers.

3.4. In the RIA, Ofgem described two specific issues relating to non-discrimination. These were:

- ◆ no undue discrimination between the treatment of the RDNs and the IDNs by the NTS; and
- ◆ no undue discrimination between DNs and other NTS offtake points.

No undue discrimination between DNs

3.5. One of the key considerations of the Offtake RIA was to ensure that the arrangements delivered a framework to ensure offtakes from the NTS would be provided on a basis that was not unduly discriminatory. This included ensuring (among other things) that there would be no undue discrimination by Transco's NTS between the IDNs and Transco's RDNs.

3.6. Unduly discriminatory conduct would occur if Transco were to behave in a way that conferred a commercial advantage on its RDN businesses without making the same benefit available to each IDN. Of particular concern are any opportunities for unduly discriminatory conduct that could arise when Transco makes operational and investment decisions, shares information between business units, and when it allocates shared costs. These concerns are described below.

3.7. First, Transco could operate its NTS and RDN businesses to maximise the benefits to the company in a way that disadvantages IDNs. For instance, undue discrimination could arise in relation to the allocation of scarce offtake rights, operational management of flow rate flexibility and diurnal storage and scheduling of maintenance.

3.8. Second, Transco's NTS business could share commercially sensitive information with RDNs about the operations and intentions of the IDNs. For instance, contractual offers made by IDNs to the NTS could be notified to an RDN, thus placing the RDN in a commercially advantageous position. Further, the NTS could potentially share certain operational information with RDNs that could

crucially affect the value of interruption but not provide this information to the IDNs at the same time.

- 3.9. Third, Transco could (subject to the standard of business separation recommended) provide a cross subsidy to the RDN businesses by allocating costs to the NTS which more properly should be met by the RDNs. This would have the effect that IDN customers would be obliged to cover costs that should be borne by RDN customers.

No undue discrimination between NTS offtake points

- 3.10. In addition to preventing discrimination between DNs, the offtake arrangements should deliver a framework in which the risk of Transco discriminating unduly between DNs and parties who hold agreements with Transco at other NTS exit points is minimised. The arrangements should therefore be developed in a way that delivers non-preferential treatment between the DNs and holders of (Network Exit Agreements) NExAs, Connected System Agreements (including those applicable to interconnectors) and Storage Connection Agreements (SCAs) as these are all other direct connectees of the NTS.
- 3.11. There is the potential for this form of undue discrimination to distort decision making both in the long and short term. In the long term, the absence of a single and consistent set of NTS exit capacity charging arrangements across all offtake points, may distort Transco's investment decision-making. In the short term, Transco may discriminate in operational decision making (e.g. providing flow rate flexibility in an unduly discriminatory way).

Economic and efficient network development

- 3.12. Ofgem considered that the offtake arrangements should deliver a framework in which there are incentives – on both network owners and network users – to make clear commercial signals, leading to efficient system planning and operation. This means that the framework should provide an incentive for both the DNs and network users to reveal their true needs for NTS offtake capacity, in timescales appropriate for the planning of necessary investment. In addition, the framework should ensure that the NTS responds to these signals.

Security of Supply

- 3.13. Consistent with Ofgem's general Duty (set out in Section 4AA(5)(c) of the Gas Act) to "secure a diverse and viable long-term energy supply", the Offtake RIA considered security of supply to be an important issue in the development of the offtake arrangements. It is therefore essential that the arrangements are developed in such a way that ensures market participants, including the NTS, the RDNs and the IDNs are incentivised to manage security of supply efficiently.

Effect on competition

- 3.14. Ofgem considered that the offtake arrangements should be developed in such a way that protects – and where possible promotes - competition in wholesale markets and retail markets. There is a risk that the sale of DNs could weaken competition in these markets as a consequence of disparate network ownership. For example, should network operation become fragmented, the complexity of associated business processes and procedures could increase (including arrangements for network charging). Such increases in complexity have the potential to increase the costs to industry participants, and hence have a detrimental effect on wholesale competition through raising barriers to market entry.
- 3.15. In a number of areas however, Ofgem was of the opinion that the DN sale process may lead to a promotion of competition in the gas market. This opportunity may be strongest in the wholesale market – in particular through the pricing of new services. One example of this is flexibility (i.e. diurnal storage) where a clear set of offtake arrangements may enable transparent pricing, efficient allocation and more efficient network development over the longer term. In particular, the DN sale process may lead to innovations in the commercial business of DNs – such as the agreement of new contracts with end customers.

Accountability and regulatory involvement

- 3.16. Ofgem considered that the offtake arrangements should define a framework that requires minimal ongoing regulatory intervention. If the arrangements clearly define all of the operational and commercial responsibilities of parties to the

arrangements, then Ofgem's role in the arrangements should be limited to that of providing oversight.

Governance arrangements

3.17. The Offtake RIA stated that governance of the offtake arrangements should be designed in accordance with the following principles:

- ◆ **No undue discrimination.** The governance for the offtake arrangements should reduce the risk of any undue discrimination between parties. Therefore decisions should be made with reference to predefined objectives (and 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.

Options for offtake arrangements

3.18. The Offtake RIA outlined high level options for four key elements of the offtake arrangements. These were:

- ◆ **NTS exit capacity rights allocation** - the process through which rights of offtake from the NTS are allocated to users of the NTS;
- ◆ **diurnal storage and operational flows** - how the flexibility inherent within the NTS is allocated, both in the long term and the short term, to users of the NTS;

- ◆ **the extent of business separation** - the extent to which the NTS and RDNs should be required to separate to engender a greater degree of equality of treatment between RDNs and IDNs; and
- ◆ **governance arrangements** - the framework within which the arrangements will evolve over time.

3.19. The options for each of these were developed through the workgroup processes, and are summarised in the following sections.

NTS exit capacity rights allocation

3.20. The Offtake RIA noted that a generic feature of all of the options for NTS exit capacity was the choice of the way in which NTS exit capacity was assumed to be released by Transco as NTS owner. The two broad approaches outlined were:

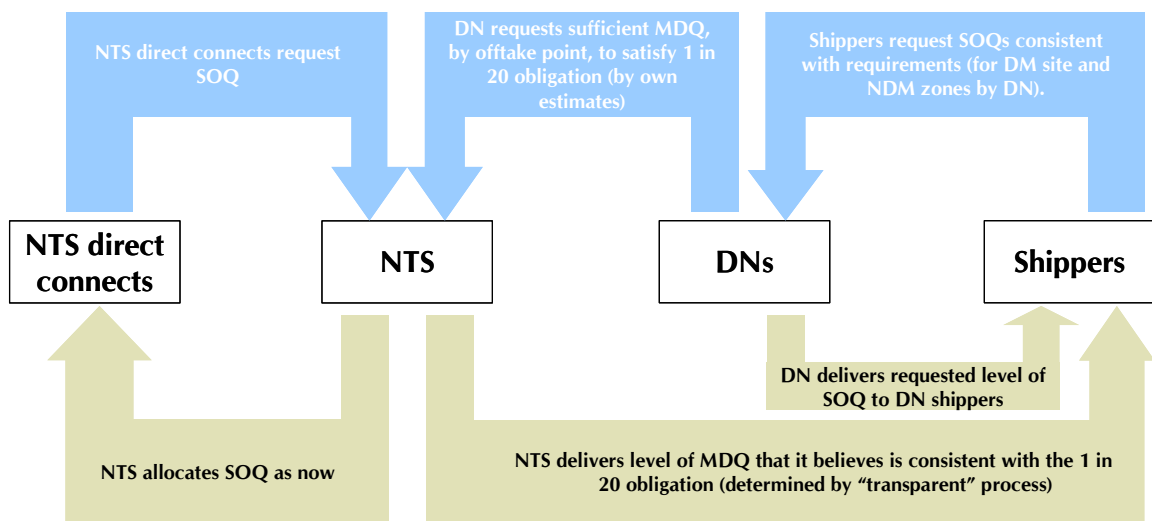
- ◆ **unconstrained allocation.** Under this approach, network owners would provide capacity to all users of the network, both existing and any new users, as requested by those users. Users would pay the regulated charge for the amount of capacity they request. In some cases, this capacity purchased by users might be in excess of the physical characteristics of the network at some locations on the network. Hence, there would exist the possibility that, under this approach, the demand for use of the capacity requested and purchased by users would, in aggregate, exceed what the network can physically deliver. In these cases, the network owner would buy back capacity rights from some of those users that originally purchased it to ensure that, in aggregate, the rights held and used by network users would not exceed the capacity of the network; and
- ◆ **constrained allocation.** Under this approach, the amount of capacity available to users would be released in a manner that is consistent with the physical capacity of the network. Hence, network users, both existing and new, would be able to acquire capacity to use the network to the extent that it is available. In cases where demand exceeds supply of capacity, it would be necessary to consider a method of allocating the scarce network capacity in a non-discriminatory manner.

3.21. The Offtake RIA outlined four proposed alternatives for the allocation of primary offtake rights under the offtake arrangements.

Option 1 - Transco's initial proposal

3.22. This option was proposed by Transco on the basis that it most closely reflects its current internal procedures for allocating capacity at NTS and DN offtake points. The process for requesting and allocating capacity under this proposal is summarised in Figure 3.1.

Figure 3.1 Overview of Option 1



3.23. In Option 1, the process of allocating capacity as described in the RIA was very similar to the current Transco internal processes, in that:

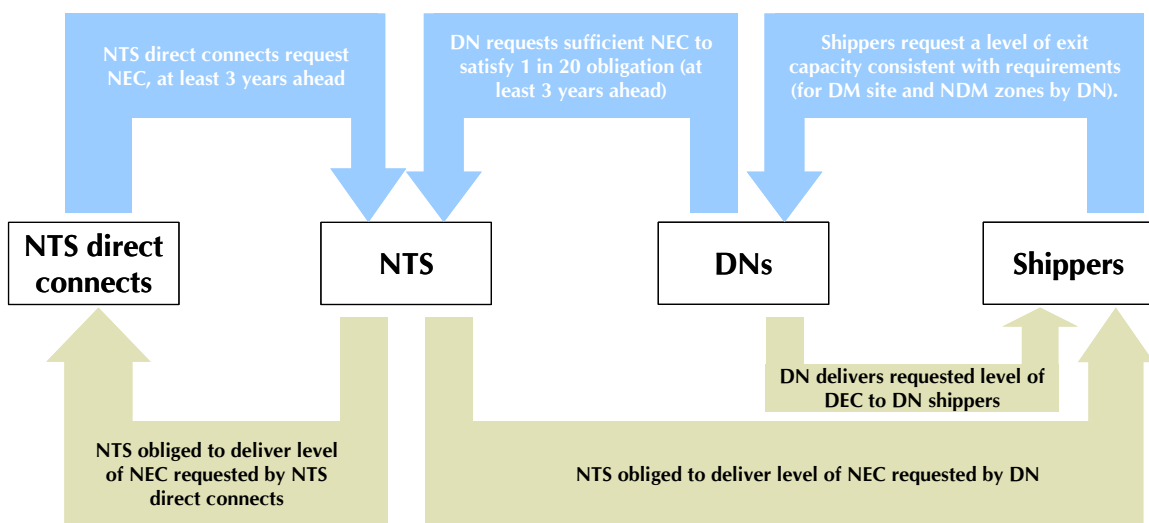
- ◆ DNs (i.e. RDNs and IDNs) would submit a request for maximum daily quantity of offtake in the year (MDQ) for each offtake from the NTS, consistent with that DN's estimates of the level of MDQ that would meet the 1 in 20 obligation for its DN;
- ◆ NTS direct connects would submit Supply Offtake Quantities (SOQs) directly to the NTS (i.e. the maximum daily consumption for a supply point);
- ◆ once the NTS received these requests it would allocate MDQs to each DN offtake point; and

- ◆ in allocating MDQs, the NTS would also be subject to the 1 in 20 obligation.

Option 2 - NTS connects booking model

3.24. Under Option 2, DNs would have prime responsibility for the capacity allocation process. Also DNs and NTS direct connects would receive equal treatment of capacity allocation. The NTS exit capacity (NEC) allocation process under Option 2, as outlined in the RIA is presented in Figure 3.2.

Figure 3.2 Overview of Option 2



3.25. The key features of the capacity booking process under this option, as presented in the RIA were that:

- ◆ DNs would estimate the level of NTS exit capacity at each NTS/DN offtake point it believes necessary to meet its, DN specific, 1 in 20 obligation;
- ◆ NTS direct connect shippers would estimate the level of NTS exit capacity they require at their offtake points;
- ◆ DNs and NTS direct connects would use these estimates as the basis for the NTS exit capacity requests they submit to the NTS;
- ◆ NTS exit capacity submissions by both DNs and NTS direct connects would be submitted consistent with investment planning timescales (i.e. indicative five years ahead, and firm for three years ahead);

- ◆ the NTS would be required to deliver the level of NTS exit capacity requested at each NTS offtake point by DNs and NTS direct connects (through either investment or interruption agreements);
- ◆ shippers would submit DN Exit Capacity requests to DNs (by daily metered site and non daily metered zone); and
- ◆ DNs would deliver the level of DN Exit Capacity requested by DN shippers.

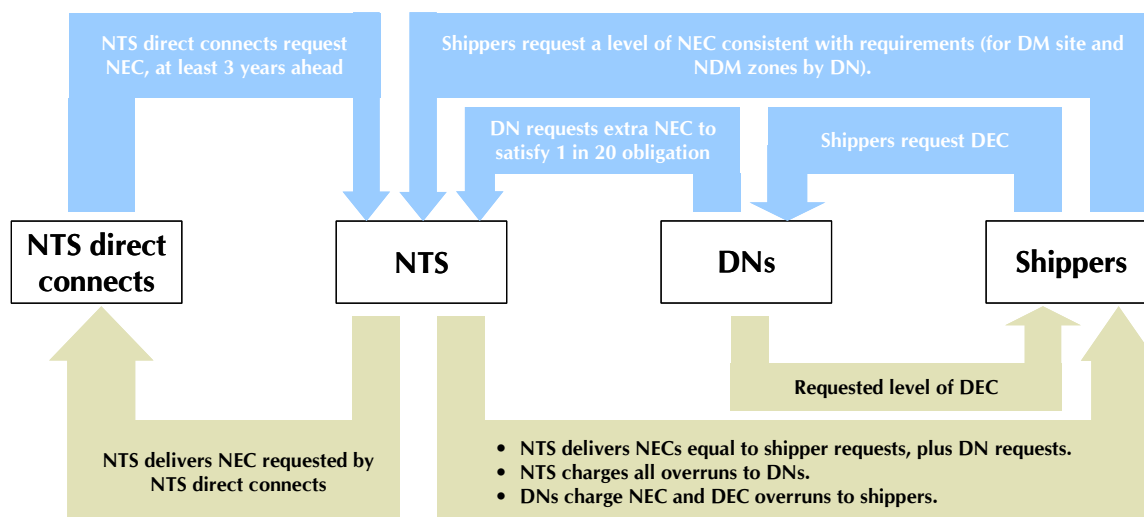
3.26. The Offtake RIA also described a variant on Option 2, in which shippers that use DNs would be given the opportunity (but not the obligation) to request their NTS exit capacity requirements directly from the NTS. In effect this would enable shippers that use DNs to bypass DNs in the NTS exit capacity allocation process, yet leave DNs with the residual responsibility of ensuring that the overall level of NTS exit capacity requested at each NTS offtake point was consistent with the 1 in 20 obligation.

3.27. In addition, the RIA described two alternatives for payment flows under Option 2. In Option 2A, DNs would effectively act as an intermediary for all NTS-related payments from DN shippers, with DN shippers making no payments directly to the NTS. Under Option 2B, however, DN shippers would make NTS-related payments to the NTS, and DN-related payments to DNs. In addition, Option 2B required DNs to make no payments directly to the NTS.

Option 3 - Shipper booking model (with DN “top-up”)

3.28. The NTS exit capacity allocation process under Option 3 is outlined in Figure 3.3 below.

Figure 3.3 Overview of Option 3



3.29. The two defining characteristics of this option were:

- ◆ DN shippers would determine their own NTS exit capacity requirements; and
- ◆ the DN would retain the 1 in 20 obligation.

3.30. The key features of the booking process under this option were therefore:

- ◆ DN shippers would be obliged to enter NTS exit capacity requests directly to the NTS;
- ◆ the DN would submit an additional NTS exit capacity request, calculated as being the difference between the level of NTS exit capacity the DN considers necessary to satisfy its 1 in 20 obligation, and the aggregate quantity of NTS exit capacity already requested by DN shippers (if this is lower, in aggregate than the DN shippers' requests);
- ◆ NTS direct connects would submit NTS exit capacity requests consistent with their requirements (as in Option 2);
- ◆ NTS exit capacity requests would (as in previous options) be consistent with investment planning timescales to enable the NTS to deliver the level of NTS exit capacity requested through a combination of investment and interruption agreements;

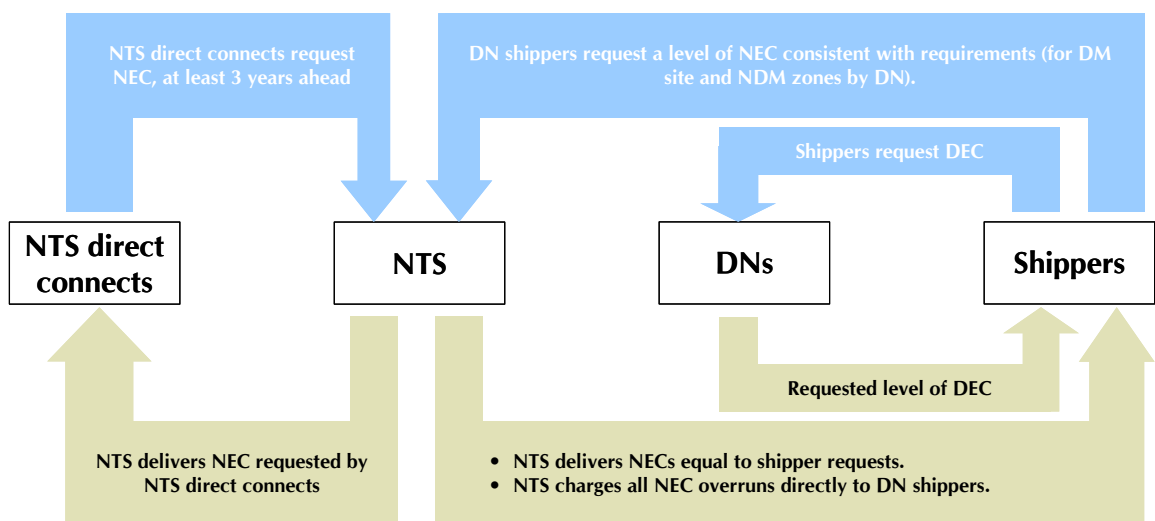
- ◆ DN shippers would submit DN exit capacity requests to the DNs, on a site specific basis for Daily Metered (DMs) and zonally for Non-Daily Metered demand (NDM) on an annual basis, as now; and
- ◆ DNs would deliver the level of DN exit capacity requested by DN shippers (through investment or interruption agreements).

Option 4 - Shipper booking model (without DN “top-up”)

3.31. As described in the Offtake RIA, the capacity allocation process in Option 4 was led by all shippers (both those within DNs and those directly connected to the NTS), who would request their NTS exit capacity requirements directly from the NTS. A consequence of giving shippers responsibility for booking NTS exit capacity was therefore that the 1 in 20 obligation would be removed from DNs. In the RIA, Ofgem recognised explicitly that the adoption of this option would require consultation with the Health and Safety Executive, and detailed consideration of the most efficient way of ensuring security of supply is maintained.

3.32. Option 4 is illustrated in Figure 3.4 below.

Figure 3.4 Overview of Option 4



3.33. Under this option:

- ◆ DN shippers and NTS direct connects would request a level of NTS exit capacity consistent with their forecast requirements (in timescales consistent with investment planning – i.e. for at least three years ahead);
- ◆ the NTS would be obliged to deliver the requested level of NTS exit capacity (as in options 2 and 3);
- ◆ DNs would not request NTS exit capacity (and would have no need to do so, given the removal of the 1 in 20 obligation); and
- ◆ DN shippers would request their required level of DN exit capacity from DNs, which DNs are obliged to deliver.

3.34. Option 4 would also require the implementation of sufficiently robust “use it or lose it” provisions on the holding of capacity rights to ensure that there could be no hoarding of capacity rights by individual shippers.

3.35. An alternative to this model, also presented in the RIA, was a variant in which shippers were permitted to allow DNs to act as their “agent” in the booking of NTS exit capacity. In this model, shippers would still retain the primary responsibility for booking NTS exit capacity, yet DNs would request NTS exit capacity for shippers if requested to do so by that shipper.

DN incentives in the proposed options

3.36. The RIA also stated that Options 2 and 3 would both involve the placing of appropriate incentives on DNs. This incentive scheme would need to be designed to discourage the DNs from the potential natural tendency to over-request NTS exit capacity from the NTS that could exist under the options in which the DNs are required to request this capacity. The scheme would therefore encourage the optimisation of any potential to trade-off NTS exit capacity requests with DN investment.

Diurnal storage and operational flows

3.37. The RIA outlined two alternative approaches for the allocation of diurnal storage and arrangements for operational flows in the offtake arrangements:

- ◆ Option A - a “planned” approach, in which diurnal storage is allocated to DNs by the NTS, and operational flows are rule-based; or
- ◆ Option B - a market based allocation and pricing of both diurnal storage and operational flow parameters.

Option A - “planned” approach

3.38. Under this option (based upon Transco’s original proposal) diurnal storage rights would be allocated by the NTS to DNs on a similar basis to now (without charge). Rights to flow above or below the defined operational flow rates would be determined according to a set of rules defined by the NTS. Hence, alongside the specification of NTS exit capacity for each NTS/DN offtake point, there would be set of parameters defining both the level of diurnal storage available and operational flow requirements. In this option, these rights would therefore be allocated to the DN irrespective of the option selected for the setting of the level of primary rights.

Option B – market based allocation

3.39. An alternative approach would be to allocate diurnal storage rights (and rights to flow above or below the defined operational flow rates) on a non-discriminatory basis at all NTS offtake points. Allocation according to market-based principles (rather than being determined through a codified set of arrangements, based on current practice) is likely to lead to a different allocation of flexibility rights than those that would arise under Option A.

3.40. This approach could give DNs and other NTS offtakes (as well as the NTS, to the extent that it requires diurnal storage from DNs) the opportunity to signal the value they place on both diurnal storage rights, and the right to deviate from predefined operational parameters. Although the exact form of the allocation arrangements for both diurnal storage and the right to deviate from operational flow parameters would require more detailed work, in principle this would enable those parties who value the flexibility the most to acquire it. This would enable prices to emerge for both sets of rights, hence leading to a more efficient allocation of scarce NTS flexibility. This is in contrast to Option A in which rights for flexibility are allocated on a planned basis.

Business separation

3.41. The Offtake RIA presented three options for business separation between Transco's NTS and Transco's RDNs.

Option 1: Transco's original proposal

3.42. As described in the RIA, Option 1 would permit Transco to retain its existing level of business separation between NTS and RDNs, with further safeguards being provided through the adoption of targeted rules and licence conditions.

Option 2: Structural separation

3.43. Option 2 placed structural separation between the NTS and the group of RDNs, including information separation, operational separation and physical separation. This degree of separation would be enforced through the GT licence.

Option 3: Legal and structural separation

3.44. The RIA also described a final Option, identical to Option 2, yet with the NTS and the group of RDNs being placed in two separate legal entities (with two separate gas transporters licences). This Option would therefore involve the group of RDNs being legally distinct from the NTS by way of a separate licensed company.

Governance of the arrangements

3.45. The Offtake RIA stated that there were a number of specific issues relating to governance of the offtake arrangements that required consideration – the most significant of these being the relationship between the arrangements and Transco's Network Code. Ofgem considered that governance should be robust enough to ensure that the offtake arrangements can evolve efficiently and effectively.

3.46. In the Offtake RIA, Ofgem considered that there were two potential alternatives for the governance of the offtake arrangements. These were:

- ◆ **Governance under Transco's Network Code (or an alternative inclusive code covering all offtake arrangements).** Under this alternative, all

connectees to the NTS would be parties to the offtake arrangements (including shippers and DNs). This would enable users as well as network operators to propose modifications to the arrangements.

- ◆ **Offtake Code.** The alternative approach would be to design offtake arrangements as a set of operator to operator obligations. Given that only network operators would be permitted to be parties to the offtake arrangements in this form, this would imply a set of separate arrangements between the NTS, and other NTS direct connects. The offtake arrangements would then be governed separately from the Network Code, hence shippers would not have the opportunity to propose modifications to offtake arrangements.

Ofgem's analysis of different options

3.47. In the Offtake RIA, Ofgem analysed each of the options for NTS exit capacity, diurnal storage and operational flows and business separation against the key issues set out above in paragraph 3.2. A summary of the analysis presented for each is provided below. Note that a complete description of Ofgem's assessment of each option is provided in the original RIA document. Hence we discuss in turn Ofgem's original views on:

- ◆ NTS exit capacity;
- ◆ diurnal storage and operational flows; and
- ◆ business separation.

NTS exit capacity

3.48. In this section we outline Ofgem's views against the key issues, as set out earlier in this chapter, and then provide a summary of the qualitative and quantitative analysis presented in the Offtake RIA.

No undue discrimination

3.49. Ofgem indicated that, of the four options, Option 1 (the baseline option) had the greatest potential for undue discrimination. As discussed in detail in the workgroups, the allocation decision would be subjective under Option 1 and as

the final decision would reside with Transco there would be the potential for the NTS to treat the IDNs and RDNs in a discriminatory manner.

- 3.50. Option 2 was considered by Ofgem to have a benefit of reducing the potential for undue discrimination in the offtake arrangements (due to the placing of the 1 in 20 obligation on DNs, and obliging the NTS to deliver the level of NTS exit capacity requested). This would result in DNs being placed at the heart of the arrangements rather than the NTS.
- 3.51. Options 3 and 4 were also considered to be similarly effective in reducing the potential for undue discrimination in the allocation of NTS exit capacity. This is because, in both options, the NTS is required to provide the level of NTS exit capacity requested by the DNs and/or shippers.

Economic and efficient network development

- 3.52. In the RIA, Ofgem outlined a concern that Option 1 would not deliver an efficient approach to network development, as under this approach, DNs would not be charged for NTS exit capacity, therefore DNs would have a natural incentive to overstate their NTS exit capacity requirements.
- 3.53. In contrast, Option 2 proposes specifying an incentive arrangement for DNs, designed to ensure that DNs are exposed to the costs (benefits) of over (under) requesting the NTS exit capacity they require (compared to expected levels of NTS exit capacity requested). This would deliver a more efficient solution than Option 1.
- 3.54. Option 3, for the same reasons as above, would deliver a similar increase in efficiency benefits over Option 1. Ofgem considers, however, that Option 4 would have the potential to deliver the biggest efficiency gains. This is because DNs would not be involved in the NTS exit capacity allocation process; as such, shippers would request exactly what their customers required. In addition, shippers would have a strong incentive to increase the accuracy of their forecasts of customer requirements, further increasing the efficiency of the arrangements.

Security of Supply

- 3.55. In all of the options, it was assumed that the NTS exit capacity arrangements would be consistent with the ongoing preservation of security of supply. As a

result, security of supply was not used as a means to differentiate between the four options.

Effect on competition

- 3.56. Option 2 was considered to be positively beneficial for competition relative to Option 1, as under this approach, there would be no scope for undue discrimination by the NTS. Option 3 was also considered to have a beneficial effect on competition, given that under this alternative, shippers would have the option of requesting NTS exit capacity directly from the NTS (rather than being required to request NTS exit capacity from the DN).
- 3.57. Finally, Option 4 was considered to remove a number of distortions in the capacity allocation process, and place greater onus on shippers to reveal their requirements for both NTS exit capacity and DN exit capacity, leading to increased efficiency of competitive markets. It should be noted that the effect of competition on each of the options was not assessed quantitatively in the Offtake RIA, given that the size of these benefits will depend upon the inevitably uncertain evolution of the markets in question.

Accountability and regulatory involvement

- 3.58. Ofgem considered that adoption of Option 1 would incur significant ongoing costs, given the greater probability of dispute between NTS and DNs concerning NTS exit capacity allocation. As a result, there would probably be the need for some form of dispute resolution process, most likely involving ongoing (and costly) regulatory intervention.
- 3.59. In contrast to Option 1, Option 2 clearly assigns responsibility for determining the level of NTS exit capacity required at each offtake point to the DN, therefore Ofgem considered that there will be a reduced need for ongoing regulatory intervention. Ofgem also considered that the costs of implementation of Option 2 would be unlikely to be significantly more than Option 1.
- 3.60. Options 3 and 4 were considered by Ofgem to be the most costly of the alternatives considered, as these options would require shippers to undergo the greatest extent of change in the NTS exit capacity allocation process. In contrast to Option 1, however, both of these options would require less ongoing regulatory intervention, once fully implemented.

NTS exit capacity: summary

3.61. Table 3.1 summarises Ofgem’s initial assessment of the costs and benefits associated with each Option for NTS exit capacity allocation as outlined in its June 2004 RIA. The table includes both a quantitative and qualitative assessment. In terms of the quantitative analysis, Ofgem chose Option 1 as the base case. As such, Options 2, 3 and 4 are assessed in quantitative terms as a variation on Option 1.

Table 3.1: Summary of costs and benefits for each option

Issue	Option 2	Option 3	Option 4
No undue discrimination between networks	✓ ✓	✓ ✓	✓ ✓
Economic and efficient network operation and development	✓ ✓ ✓	✓ ✓ ✓	✓ ✓ ✓
Security of supply	-	-	-
Effect on competition	✓ ✓	✓ ✓	✓ ✓
Accountability			
◆ Less regulatory involvement	✓ ✓	✓ ✓	✓ ✓
◆ Implementation cost	✗	✗ ✗	✗ ✗
Net increase in potential benefit relative to Option 1	£27.1m	£18.6m	£33.2m

3.62. Ofgem indicated that it was minded to support Option 4 as it appears to have clear advantages over the other options (in both quantitative and qualitative terms). However, Ofgem recognised that it may be impractical to move directly to Option 4 at this stage, and stated that it may be preferable to adopt Option 2 initially, whilst also potentially allowing shippers the opportunity to book capacity directly from the NTS if they should wish to do so. Ofgem considered that this would allow further consideration to take place concerning the current network planning obligations and the appropriateness or otherwise of such obligations going forward.

Diurnal storage and operational flows

3.63. In this section we outline Ofgem's views against the key issues, as set out earlier in this chapter, and then provide a summary of the qualitative and quantitative analysis presented in the Offtake RIA.

No undue discrimination

3.64. Ofgem considered, in the Offtake RIA, that under Option A, the NTS would have significant potential to unduly discriminate in the allocation of "secondary" NTS exit capacity rights¹³. Ofgem concluded that this would have the potential to lead to an inappropriate allocation of these secondary rights between IDNs and RDNs. In certain circumstances, Ofgem considered that this could lead to increased costs for customers.

3.65. In contrast, Ofgem stated in the RIA, that the allocation of secondary rights under Option B would be more efficient than in Option A, given that allocation of rights would be made on a non-discriminatory basis.

Economic and efficient network development

3.66. In the Offtake RIA, Ofgem stated that Option A would be a relatively inefficient alternative, as it would specifically treat diurnal storage as an operator-to-operator product that would not be charged for. This would, in turn lead to a suboptimal and inefficient allocation of flexibility between offtake points.

3.67. Ofgem considered Option B to be an alternative in which the allocation of flexibility would be more efficient than Option A (given that this option would enable both DNs and NTS direct connect customers to signal the value they place on flexibility of flow rates). In addition, Ofgem stated that the pricing of flexibility at offtake points may have benefits in terms of savings in the cost of energy balancing actions undertaken by Transco as System Operator.

Security of Supply

3.68. In all of the options, it was assumed that the arrangements for allocation of diurnal storage and operational flows would be consistent with the ongoing preservation of security of supply. As a result, security of supply was not used as a means by which to differentiate between Options A and B.

¹³ i.e. diurnal storage and operational flows.
NGT – Potential sale of network distribution businesses
Office of Gas and Electricity Markets

Effect on competition

- 3.69. Ofgem considered that Option B would be more beneficial in terms of effect on competition, relative to Option A. This is because, under this alternative, there would be effective competition between all users of the network for flexibility rights, and the potential for efficient pricing.

Accountability and regulatory involvement

- 3.70. Ofgem considered that Option A, under which the NTS determines the level of flexibility provided at NTS offtake points, could have the potential to cause significant levels of dispute, particularly after year three (after which the NTS would have greater discretion to allocate the level of flexibility at offtake points it considers appropriate). Ofgem stated in the RIA that this could potentially increase the level of ongoing regulatory involvement and, as such, raise the level of cost.
- 3.71. In contrast to Option A, Option B allows NTS offtake parties to determine the level of flexibility they require, and as such there will be less need for ongoing regulatory intervention. Ofgem also considered that the additional costs of implementation of Option B would be minimal relative to those of Option A (despite the relatively greater level of change).

Diurnal storage and operational flows: summary

- 3.72. Table 3.2 summarises Ofgem's initial assessment of the costs and benefits associated with each Option for allocation of flexibility rights, as outlined in its June 2004 RIA. Once again, the table includes both a quantitative and qualitative analysis, and evaluates Option B with reference to the base case of Option A.

Table 3.2: Summary of evaluation of diurnal storage and operational flow options

Issue	Option B
No undue discrimination between networks	✓ ✓
Economic and efficient network operation and development	✓ ✓
Security of supply	-
Effect on competition	✓ ✓
Accountability	
◆ Less regulatory involvement	✓ ✓
◆ Implementation cost	✗
Net increase in potential benefit relative to Option A	£11.7m

3.73. Ofgem therefore considered that Option B was the preferred way of designing offtake arrangements for diurnal storage and operation flows (given that this alternative offered clear quantitative and qualitative advantages over Option A).

Business separation

3.74. In this section we outline Ofgem’s views against the key issues, as set out earlier in this chapter.

No undue discrimination

3.75. Of the three options in relation to business separation, Ofgem considered that Option 1 (Transco’s proposals) would lead to a risk of undue discrimination, leading to the potential for less efficient network operation. Ofgem believed that information, operational and physical separation would decrease the risk of undue discrimination in the arrangements, yet that the legal and structural separation proposed under Option 3 would most effectively reduce the potential for undue discrimination. This is because legal and structural separation would significantly reinforce the delineation between the businesses.

Accountability and regulatory involvement

3.76. Ofgem considered that Option 1 would involve the implementation of a complex set of targeted rules and licence conditions, which would need to be

detailed and prescriptive. In contrast, Ofgem stated that a rigorous approach to business separation could reduce regulatory complexity more effectively.

3.77. On the other hand, Ofgem also believed that the level of business separation implied by Options 2 and 3 may have a negative impact on the cost and other terms of Transco’s exiting and future borrowings. These options may also involve significant implementation costs (all of which would be borne by Transco).

Business separation: summary

3.78. Table 3.3 summarises Ofgem’s qualitative analysis of the benefits of the different levels of business separation.

Table 3.3: Forms of business separation required under each option

	Option 1	Option 2	Option 3
Licence conditions requiring non-discrimination	✓	✓	✓
Information separation	✓ (partial)	✓	✓
Operational separation	✓ (partial)	✓	✓
Physical separation	✗	✓	✓
Legal separation	✗	✗	✓

3.79. Ofgem considered Option 3 to be the most appropriate option in terms of business separation. In addition, Ofgem considered that any implementation costs incurred by Transco in the separation of its NTS and RDN businesses should not be passed through to customers.

4. Respondents' views

4.1. This chapter summarises the views received from respondents to the Offtake RIA document. It outlines respondents views on the following:

- ◆ NTS exit capacity;
- ◆ Diurnal storage and operational flows;
- ◆ Business separation;
- ◆ Governance;
- ◆ Security of Supply;
- ◆ Cost benefit analysis; and
- ◆ Other issues.

NTS exit capacity

4.2. Of the fifteen responses received, seven preferred a form of Option 2 for the allocation of NTS exit capacity. Two of these had a preference for Option 2A, and one had a preference for Option 2B. Generally, those favouring Option 2 believed that this alternative would not involve the drastic change implied by Options 3 and 4, yet would reduce the risk of undue discrimination by Transco, preserve security of supply and deliver a clear allocation of responsibilities between parties. A number of respondents were concerned about the difficulties involved in developing an effective DN incentive regime that would be necessary under this option.

4.3. Of the Option 2 alternatives, Transco had a preference for Option 2B, as it believed that this option could be accommodated under the existing commercial and regulatory framework. In contrast, one respondent opposed Option 2B, as it believed this would require DNs to provide shippers with (costly) credit guarantees. Another preferred Option 2A as it believed that this was more in the spirit of the "active DN" model.

- 4.4. Of those respondents that expressed a preference, all believed that the variant of Option 2 in which shippers had the opportunity but not the obligation to request NTS exit capacity directly from the NTS would lead to more cost and complexity without any added benefit. Transco also believed that this variant would be impractical due to concerns over the accuracy of resulting investment signals and the extent of change required.
- 4.5. Six respondents indicated a preference for an Option 1- type set of NTS exit capacity arrangements, with two believing that additional safeguards would be required for Option 1 to be acceptable. One respondent believed that additional licence conditions relating to no undue discrimination combined with full business separation would deliver sufficient safeguards, whereas another stated that Option 1 would be acceptable so long as it was combined with an additional licence condition requiring network operators to cooperate in planning network investment.
- 4.6. Some respondents stated explicitly that Option 1 would not be an appropriate form for NTS exit capacity arrangements. Specifically, one respondent believed that under this option, the NTS would be likely to discriminate between the RDNs and the IDNs, and that there would be an incentive for the DNs to over-request capacity. Of the remaining respondents who were uncertain about the merits of Option 1, one believed that more detail would need to be provided before it could make an informed choice.
- 4.7. None of the respondents favoured Option 3, with a majority stating explicitly that they opposed this alternative. Most believed that this option would be too costly to implement, and that they did not believe the benefits would be as high as indicated in the cost benefit analysis. Many stated that this option would involve more change than that necessary for the implementation of DN sales, and that it would involve the transfer of significant extra risk to shippers. A number of respondents also stated that they had concerns surrounding security of supply under this option, given that it was shipper-led. Transco believed that this alternative would be inconsistent with the current statutory framework (specifically the Gas Act that states only shippers may enter into transportation arrangements with gas transporters).
- 4.8. Almost all respondents stated that they opposed Option 4, although one respondent stated that despite it being a costly alternative, this Option would

offer the most flexibility to shippers. Most respondents had serious security of supply concerns with this Option, and one respondent believed that the removal of the 1 in 20 obligation may contravene the (forthcoming) EU Gas Security Directive. The HSE had serious concerns over this Option, and stated that Option 4 would need to satisfy their “safe as existing arrangements or better” test before they would be able to give their consent.

- 4.9. Many respondents believed that the investment signals provided by shippers under this Option would either be weak or inaccurate. Respondents believed that there was a significant chance of over-investment, with shippers overstating their NTS exit capacity requirements, potentially resulting in the stranding of assets. In addition, some respondents believed that this Option had the potential to distort retail competition, due to concerns that dominant shippers would exercise market power. One respondent considered that the effect on competition had not been considered in the Offtake RIA. A number of respondents also believed that the costs included in the cost benefit analysis were insufficient for Option 4, and that the benefits were overstated.
- 4.10. Ofgem also notes the views of a number of respondents that insufficient detail was provided in the Offtake RIA for respondents to be able to make a proper assessment of the options described. A number of respondents also stated that the costs and benefits of the options could be improved in a number of places. One respondent also stated that no comparisons of experience in other countries had been considered in relation to NTS exit capacity reform. In addition, numerous respondents stated that the secondary market for NTS exit capacity (under Options 3 and 4) is likely to be illiquid.

Diurnal storage and operational flows

- 4.11. Eleven of the fifteen respondents believed that Option A was the most appropriate alternative for diurnal storage and operational flows, with one respondent favouring Option B. Transco believed that Option A was the most appropriate short term model, but believed that there was some merit in developing a commercial approach similar to Option B, which would enable DNs and NTS direct connects to signal the value they place on diurnal storage. Transco believed that it would be possible to commercialise operational flows in the same framework.

- 4.12. Many respondents believed that developing a market mechanism for diurnal storage would be overly complex, and one respondent stated that the benefits included in the RIA were insufficient to warrant such an approach. Two respondents stated that Option B for diurnal storage contradicted the findings of industry Review Group 513, which concluded that a linepack service could undermine liquidity at the NBP, and reduce competition. A number of respondents believed there was no appetite in the industry for a diurnal storage product, and that secondary markets would not develop. One respondent believed that a variant of Option A may be appropriate, in which administered prices are defined, allowing network operators to value flexibility.
- 4.13. Another respondent did not feel that the cost benefit analysis for Option B was accurate, and believed that the costs would outweigh the benefits. In addition, it believed that Option B could increase balancing costs, lead to overinvestment, and also required a guarantee that any costs incurred would not be passed on to customers. One respondent felt that the industry, rather than Ofgem, should judge when it was appropriate for competition in diurnal storage to develop, and a number of respondents believed that setting levels of diurnal storage should remain an operator-to-operator issue. In addition, one respondent believed it would be very difficult to enforce offtake rates, hence it was unclear how penalties for overruns would be levied. One respondent believed that adopting a market-based approach to diurnal storage allocation would mean industry paying twice for this service (as DNs do not currently have a commercial contract with Transco for this service, yet shippers pay for Transco's balancing actions).

Business separation

- 4.14. Nine of the fifteen respondents believed that there should be full legal and structural separation of the NTS from RDNs. In contrast, one respondent stated that licence conditions would be sufficient to deter undue discrimination, and another respondent felt that Option 2, requiring internal structural separation, but not full legal separation, would be sufficient to prevent undue discrimination.
- 4.15. All of the respondents that favoured Option 3 believed that only full structural and legal separation would provide satisfactory assurance that there would be no

undue discrimination between the NTS and RDNs. One respondent stated that it was not convinced by Transco's arguments against Option 3, and agreed with Ofgem that Transco's cost of debt should not influence the decision on separation. A different respondent, although supporting Option 3, believed it unlikely that additional benefits would arise were RDNs required to separate from each other. Two other respondents believed that Option 3 would be the most effective way of delivering the benefits from comparative regulation that would arise from the DN sales process.

- 4.16. Transco suggested that opportunities for undue discrimination by the NTS in favour of RDNs are limited, and that if undue discrimination occurred, it would be easily identified. Transco contend that their proposals for targeted structural separation between NTS and RDNs and other targeted regulatory measures would be effective whilst also being proportional to the true potential for undue discrimination. They argue that these proposals would represent a 'fit for purpose' measure which, in their view, would deliver a high degree of protection to IDNs against the potential for undue discrimination. Transco also makes the point that full structural and legal separation between NTS and DN monopoly activities goes much further than targeted measures introduced by Ofgem between monopoly and competitive activities where the potential for undue discrimination is much greater. They also suggest that Option 3 in the Offtake RIA goes considerably further than the arrangements proposed in relation to BETTA.

Governance

- 4.17. There was less comment on the most appropriate form of governance for the offtake arrangements. Of the seven respondents that expressed an opinion, responses were split between preference for governance through a separate operator-to-operator Offtake Code, and governance under the Network Code. The most detailed response received in relation to this issue stated that governance under an inclusive Universal Network Code would be most consistent with the principles of good governance, and would have unambiguous net advantages over a number of separately governed codes.
- 4.18. In the context of a discussion of Option 2 for NTS exit capacity, Transco proposed that a separate Offtake Code would be required to define operator-to-

operator arrangements, with all commercial arrangements between shippers and transporters associated with NTS exit capacity placed within the Network Code.

Security of supply

- 4.19. In addition to the concerns already outlined above, the majority of respondents stated that the 1 in 20 obligation should be retained under the new arrangements. One respondent favoured an option in which the 1 in 20 obligation was shared by both the NTS and the DNs for NTS offtake points. Transco believed that the NTS should continue to develop to at least the 1 in 20 standard of pipeline security in the future. In the context of Option 2, Transco believed this could be achieved by requiring the NTS to invest in response to investment signals provided by DNs (so long as DNs retained a 1 in 20 obligation).
- 4.20. In addition, one respondent believed that a market based approach to diurnal storage (Option B) would not be responsive enough to changes in requirements for additional diurnal storage. As a consequence, this respondent believed Option B could compromise security of supply.

Cost benefit analysis (CBA)

- 4.21. Some respondents stated that they would have preferred the “base case” for the analysis to be the current arrangements, so that the costs of moving to Option 1 could be more clearly understood. In particular, one respondent believed Option 1 represented a significant change from the current NTS exit capacity allocation process, and that the proposed process of requesting SOQs by shippers could have significant systems implications, not included in the CBA.
- 4.22. A number of respondents believed that cost of increased complexity in Options 3 and 4 for NTS exit capacity arrangements was not adequately reflected in the CBA, and another respondent was disappointed that shippers had not been consulted separately on the costs of the different proposals. In particular, one respondent believed that the IT costs of the options had been understated. A respondent believed that there had been a lack of consideration of transitional issues, and the costs understated.

- 4.23. A number of respondents provided updated estimates of the cost of Option 4. Most of these expressed a concern that the shipper costs were too low; rather than requiring an extra 0.25 FTE per shipper, these respondents believed that the actual cost would be in a range from 1 FTE to 5 FTEs per shipper.
- 4.24. A number of respondents felt that the benefits of preventing Transco discriminating between RDNs and IDNs had been overstated in the CBA. Two respondents also requested greater clarity on the methodology used to calculate balancing cost reductions, and another suggested that these benefits would not be realised in practice.
- 4.25. Three respondents believed that the market based options for NTS exit capacity arrangements would actually increase the ongoing cost of regulatory intervention (for example, in maintaining the DN incentive scheme and administering an allocation process). One respondent believed that increased regulatory involvement in Options 3 and 4 would increase costs (in NPV terms) by £2.5m and £5.1m respectively. This same respondent believed that implementation cost of these two options would be £8.5m (in NPV terms). In addition, one respondent believed that the cost of changes to security of supply should have been quantified in the RIA, in order to have a more accurate assessment of the proposals.

Other issues

- 4.26. A number of respondents felt that the proposals went beyond the level of change necessary for DN sales to be implemented. Some were keen to have the opportunity to respond to the overall decision on DN sales, assessing the alternatives presented in each of the RIAs released to date in a single consultation. One respondent believed that the RAWG should be reconvened to assess how DN incentives could be combined with the price control (and would favour reopening the DN price control). In addition, two respondents were concerned that they had not yet seen a clear project plan with milestones for the DN sales process. One respondent also felt that transitional issues had not been adequately considered in the Offtake RIA.
- 4.27. One respondent felt that the RIA contained insufficient detail for it to enable respondents to make an accurate assessment of the proposals, that the origin of

NPV values contained in the CBA was unclear and that the likelihood of undue discrimination occurring in a number of the options was not specified.

5. The Authority's conclusions

- 5.1. This Chapter sets out the Authority's conclusions for the issues covered in the Offtake RIA, following careful consideration of the representations received during the consultation process from interested parties. The Authority thanks respondents for the views they have submitted, and welcomes the comprehensive comments that have been provided on the options outlined in the Offtake RIA.
- 5.2. Following careful consideration of respondents' views in response to the Offtake RIA, Ofgem prepared a report and recommendation (together with supporting documents) on the way forward regarding this matter for consideration and decision by the Authority. This was considered at a duly convened meeting of the Authority where the Authority endorsed Ofgem's recommendations, namely:
- ◆ an Option 2 approach to NTS exit capacity allocation is most appropriate for implementation as part of the DN sales process;
 - ◆ for diurnal storage and operational flows, an alternate "Option A*" – an amalgam of Options A and B - should be developed for discussion through the workgroup process in the coming weeks;
 - ◆ a targeted structural separation between Transco's NTS and RDN businesses in combination with legal separation; and
 - ◆ a single governance approach to the governance of the Offtake arrangements, exploring Transco's composite framework proposal further.
- 5.3. Having made these recommendations, the Authority instructed Ofgem to proceed on its behalf. It is important to note that this is one of a series of indicative decisions reached by the Authority before its November meeting at which it expects to definitively decide whether or not it is willing to consent to the proposed sale of one or more of Transco's DNs¹⁴.
- 5.4. This matter will now be progressed by a combination of licence modification proposals, pricing consultations and network code modification proposals, all of

¹⁴ Note that, as described in paragraph 1.5, the information provided in this document is done so on an informal basis and should not be treated as binding on the Authority.

which will be given full and appropriate consideration with each judged, either by the Authority or by Ofgem under delegated authority, upon its own merits and against the applicable relevant objectives and the Authority's wider statutory duties.

5.5. This section outlines the Authority's conclusions on:

- ◆ NTS exit capacity;
- ◆ diurnal storage and operational flows;
- ◆ business separation; and
- ◆ governance.

NTS exit capacity

5.6. Having carefully considered and fully assessed the responses received to the consultation, the Authority considers that, of the different options outlined for the allocation of NTS exit capacity, Option 2 is the most appropriate for implementation as part of the DN sales process. While Option 2 has considerable advantages over Option 1, we remain concerned that users that are connected to the DNs will not have an opportunity to signal directly to the NTS the value that they place on NTS exit capacity.

5.7. There are several advantages to an Option 2 approach to NTS exit capacity allocation over an Option 1 approach, including the promotion of competition and the more economic and efficient development of network businesses - that will ultimately lead to lower costs for customers - but it is recognised that, if the costs of introducing these reforms were prohibitively high relative to the benefits, then it would not be in customers' interests to pursue these issues further. It is important that these issues are kept under review following any disposal and that the governance framework should allow the offtake arrangements to evolve, where appropriate, towards a more market based approach to determining network capacity at the DN level. However, recognising respondents' views on the challenges associated with this approach, Ofgem considers that Transco should adopt Option 2 in the event that the Authority permits the sale of one or more of Transco's DNs. The conclusions of these proposals will be developed through a combination of network code modifications, Transco pricing consultations and proposed amendments to Transco's gas transporter licence.

5.8. The Authority considered the following issues in reaching its conclusion:

- ◆ consideration of respondents' views;
- ◆ the role of incentive schemes;
- ◆ consideration of shipper-led options;
- ◆ charging arrangements; and
- ◆ cost benefit analysis.

Consideration of respondents' views

5.9. The Authority agrees with those respondents that stated Option 2 has a clear advantage over Option 1 in that it will reduce the possibility that the NTS will be able to exercise any undue discrimination over NTS connectees (including IDNs) in the allocation of NTS exit capacity, as well as delivering a clear allocation of responsibilities between parties. The Authority also notes respondents' views that Option 2 would not require such a major change as Options 3 or 4. In addition, we agree with the opinion expressed by those respondents who stated that, under Option 1, an incentive would exist for DNs (particularly IDNs) to over-request NTS exit capacity. We also note the views of one respondent who stated that Option 1 would involve a significant change from current arrangements.

5.10. The Authority considers that the extra level of change required in implementing Option 2 over Option 1 is justified by both the likely reduction in risk of undue discrimination by the NTS, as well as an improvement in the efficiency of DN investment and operational decisions in Option 2. We do not share the view of respondents that additional licence conditions in combination with Option 1 would provide a sufficient safeguard against the risk of undue discrimination that would arise under Option 1, given the current level of resource sharing between the DNs and the NTS.

5.11. Further, we consider that an obligation on network operators to cooperate in network planning does not clearly assign planning responsibilities, does not address the potential for planning disputes, and as such does not address the likely need for excessive regulatory intervention, which we consider may arise under Option 1. In

addition, Option 2 captures the majority of the quantitative benefits described in the RIA.

Role of incentive schemes

- 5.12. The Authority recognises that the implementation of Option 2 will require the design of appropriate financial incentives to ensure that the DNs make an efficient trade-off between requests for NTS exit capacity and investment within the DN (to the extent that some DN investment may be substitutable for NTS exit capacity). This issue has been the subject of recent industry workgroup discussions, and detailed design work on incentives will need to begin shortly. Some respondents raised concerns surrounding the regulatory costs of incentive schemes. Despite these representations, we continue to believe that the regulatory costs would be lower under Option 2 than those that would occur under an Option 1 approach, where the potential for disputes between network operators is higher.
- 5.13. In this respect, we also consider that an Option 1 approach will produce less reliable information relative to Option 2 for regulatory purposes in assessing investments through the price control process. As such, the regulatory costs (i.e. the costs incurred by the regulator in fulfilling its duties) associated with an Option 1 approach could be significantly higher than those under Option 2. It is also important to note that the incentives that will be applied to DNs initially are likely to be short-term in nature, given the uncertainty that is likely to exist surrounding the level of DN costs. Over the longer term –as more data on DN costs becomes available - it is envisaged that this scheme will enable costs to be reduced.

Consideration of shipper-led options

- 5.14. Many respondents stated that they believed that the shipper-led options (and in particular Option 4 in which the 1 in 20 obligation was removed), had the potential to reduce and even endanger security of supply. The Authority notes these very serious concerns, and reiterates that, should further work be undertaken on developing a shipper-led approach for booking NTS exit capacity in the future, there would need to be detailed consultation with the HSE to ensure there would be no reduction in the current level of security of supply.
- 5.15. Many respondents also stated that they believed the shipper-led options would provide poor investment signals to the NTS (leading to under- or over-investment),

and that the DN (or the NTS itself) would be better placed to determine the amount of capacity that would be required to be delivered in the future. We understand the concerns that have been expressed by respondents. However, we remain of the opinion that investment signals from users of capacity tend to reflect more accurately the likely level of future demand for capacity than central planning models developed by network owners. In particular, we consider that it is shippers rather than network operators who are best placed to understand the present and future requirements of gas customers.

- 5.16. A number of respondents also stated that the shipper-led options for NTS exit capacity had the potential to reduce retail competition, through an increase in the complexity of the customer transfer process. We consider that the shipper-led options described in the Offtake RIA are not specified to a sufficient degree of granularity to understand fully the interactions with the customer transfer process. Some respondents also stated that the shipper-led approaches to NTS exit capacity would lead to illiquid secondary markets. In the event that a shipper-led approach to NTS exit capacity allocation is assessed again in the future, implications for retail competition and liquidity of secondary markets will be key issues for consideration.

Charging arrangements

- 5.17. We note that, other than Transco, all respondents that expressed an opinion on the choice of charging arrangements favoured an Option 2A approach, in which shippers do not make any payments directly to the NTS over the Option 2B approach (hence potentially being relatively cheaper for shippers in terms of the cost of credit guarantees).
- 5.18. We also note Transco's view that it would prove difficult to implement Option 2A under current commercial arrangements. As a consequence, we consider that the choice of charging structure to be selected for inclusion in the framework under Option 2 should be discussed through the workgroup process as a matter of priority, and resolved in the coming month.

Cost benefit analysis

- 5.19. As noted in the previous chapter, some respondents stated that the costs and benefits of the options as outlined in the Offtake RIA could be improved in a number of places. The initial assessment and supporting analysis presented in the Offtake RIA

was based upon our best view of the costs and benefits from the options at the time of publication. Subsequently, respondents have provided some new data on the extent of both the costs and benefits of each option, which the Authority took into account when considering the responses. Some respondents also raised concerns that in the cost benefit analysis we did not compare the options to a baseline of status quo (although the Offtake RIA did make clear that under a sales scenario with a divested industry structure the status quo option is not a suitable comparator).

- 5.20. In response, Ofgem will be circulating a pro forma questionnaire on the costs of the proposed framework as part of the process of developing the Final RIA. Any information provided by industry participants will then be considered by the Authority in the context of the assessment of the Final RIA, and in reaching its decision in November on whether to give consent to the proposed DN sales. Following publication of the Final RIA, we will also be inviting respondents' views on the costs and benefits of moving from the status quo to the proposed arrangements.
- 5.21. In response to the view of a number of respondents that insufficient detail was provided in the Offtake RIA for respondents to be able to make a proper assessment of the options described, Ofgem reiterates that the proposals detailed in the Offtake RIA were at a high level. As a consequence, the proposals for both the NTS and DNs will be developed to a greater level of detail through a combination of modifications to industry codes, pricing consultations and proposed amendments to the Gas Transporters licence.

Diurnal storage and operational flows

- 5.22. The Authority has carefully considered the views of respondents to the Offtake RIA with respect to the selection of the most appropriate allocation option for diurnal storage and operational flows, and considers that, having regard to its statutory duties, Option A would not be acceptable for adoption as part of the DN sales process. We consider that, under Option A, there would be a significant risk of undue discrimination by the NTS between NTS connectees (i.e. between IDNs, RDNs and direct connect shippers). Option A would also fail to provide effective investment signals to the NTS, or enable the NTS to discern the value placed on NTS flexibility by different NTS connectees.

- 5.23. We consider that the benefits of an approach in which diurnal storage is allocated to those participants that value it most highly would, over the longer term, more than outweigh the extra amount of change (and associated costs) that such an approach would entail.
- 5.24. At the same time, however, we note the concerns expressed by some respondents about the lack of appetite in the wider industry for a market-based approach to diurnal storage. In addition, the Authority has considered the views expressed by a number of respondents that setting levels of diurnal storage should remain an operator-to-operator issue. We note the view expressed by one respondent who stated that market developments should be led by industry. While we recognise this view, we consider it important to design arrangements that, wherever possible, allow users to signal the value they place on resources. Further, we do not consider that a market-based approach implies that industry will be “paying twice” for diurnal storage. Indeed, we consider that the unbundling of charges for diurnal storage from the primary capacity product would increase transparency, and tend to reduce overall cost to industry (and eventually to end customers).
- 5.25. The Authority understands the concerns expressed by respondents about the complexity of a large-scale market-based approach to the allocation of diurnal storage. It also welcomes Transco’s suggestion that it would be worthwhile developing an alternative commercial approach, which would enable DNs and NTS direct connects to signal the value that they as network operators place on diurnal storage.
- 5.26. The Authority therefore considers that an alternate “Option A*” – an amalgam of Options A and B - should be developed for discussion through the workgroup process in the coming four week period. Option A* would follow a commercial approach to the allocation of diurnal storage, yet ensure that diurnal storage and NTS offtake flexibility remains a service provided by the NTS to NTS connectees (i.e. DNs and NTS direct connects). This would enable NTS flexibility to be valued according to the location on the network to which it is delivered and, when it is scarce, allocated to those that value it the most. Such a set of arrangements, however, would not involve DN shippers. We consider that this would potentially deliver the majority of the benefits outlined in the RIA as accruing to Option B, yet avoid the risk of undue discrimination involved in Option A.

5.27. Significant further work therefore needs to be undertaken on the detailed design of the arrangements for diurnal storage and operational flows. This will be undertaken through the industry workgroups, and will be performed with due regard to the views expressed by respondents to the Offtake RIA. Following this workgroup consultation, we will publish a position document that will describe the framework arrangements for diurnal storage and operational flows and this will be included in the Final RIA. We consider that this approach will be the best way to address the more detailed points raised by respondents (such as how offtake rates could, in practice, be enforced, and hence overruns charged for). In addition, this will need to address the concerns of another respondent who stated that the adoption of commercial arrangements for diurnal storage may result in different arrangements for customers connected to the NTS and DN (with the potential for a distortionary effect on markets). It will also need to ensure that the arrangements developed do not have a detrimental effect on security of supply.

Business separation

5.28. This section sets out the Authority's views on structural separation, legal separation and the treatment of costs associated with business separation.

Structural and legal separation

5.29. Having carefully considered all responses to the consultation (including Transco's additional representations), and having due regard to its statutory duties, the Authority is minded to require Transco to adopt targeted structural separation between Transco's NTS and RDN businesses in combination with legal separation. Targeted separation should ensure that there is no potential for the sharing of key staff and resources (e.g. operational staff) between the NTS and the RDNs. It would, however, allow the sharing of some specific groups of non-critical staff (e.g. support staff such as Human Resources). In addition, legal separation will require the creation of separate management Boards, and the formalisation of contractual boundaries between the businesses.

5.30. Under this option, Transco's NTS and RDN businesses would be in two legally separate entities, and Transco NTS would have a licence condition requiring no undue discrimination between RDN and IDN businesses. In addition, each legal entity would be required to have a statement in place describing the practices,

procedures and systems it has adopted in order to ensure no undue discrimination. In particular, the statement would set out how each legal entity would maintain information, operational and physical separation between the NTS and RDN businesses so as to prevent any breach of the requirement for no undue discrimination. This statement would need to be approved by the Authority and compliance would be subject to internal and external audit. Compliance with the statement would be a condition of both the NTS and RDN licence. In addition, a requirement of Transco's licence would be to appoint a compliance officer, with a clear responsibility for ensuring that business separation was implemented fully, and maintained on an ongoing basis.

- 5.31. The licence conditions introduced to support this option would be broadly modelled on the conditions that apply to electricity distribution businesses in relation to their supply businesses. The detail of Transco's statement could be developed by Transco and signed off by an independent auditor, who would confirm that the proposed statement complies with Transco's undue discrimination licence obligations. Transco's choice of auditor would be approved by Ofgem. In effect, this option would entail an enhanced version of Option 1 (including more rigorous requirements in relation to physical separation) plus legal separation.
- 5.32. The benefit of this approach is that it is consistent with the approach that Ofgem has adopted when it has previously imposed separation in relation to other regulated businesses. It will also ensure that Transco does not incur costs in order to separate parts of their business where the costs of separation are likely to exceed the benefits in terms of diminished risk of undue discrimination.
- 5.33. The Authority notes that the majority of respondents to the Offtake RIA stated that they believed Option 3 (full structural and legal separation) would provide the strongest assurance that there would be no undue discrimination between the NTS and RDNs. Whilst we agree that this is the case, it is apparent from Transco's response to the RIA that full structural separation of Transco's NTS business and the RDNs would involve substantial costs. The Authority also notes one respondent's view that licence conditions would be sufficient to deter undue discrimination, and another that considered that Option 2 (which requires structural separation but not full legal separation) would be sufficient to prevent undue discrimination.

5.34. The Authority is minded to the view that targeted structural separation, in combination with legal separation, would provide sufficient safeguards against the risk of undue discrimination by the NTS, whilst not incurring the level of cost that would result from full structural separation. This conclusion is conditional on ensuring that a number of detailed implementation issues can be resolved satisfactorily.

Treatment of costs associated with business separation

5.35. Ofgem retains the view set out in the Offtake RIA that if separation is required, the implementation costs associated with restructuring Transco's business should not be passed through to customers. This is because business separation costs would arise as a consequence of Transco's commercial decision to sell one or more DNs. Ofgem notes that one respondent requested more information on this issue.

5.36. The only mechanism by which implementation costs associated with business separation could be passed on to customers is if these additional costs were to be included in Transco's allowed revenue at subsequent price controls. Consequently, Ofgem intends that any capital costs incurred as a result of a requirement for business separation are not included in Transco's allowed revenue at future NTS and DN price control reviews. Therefore, Ofgem's approach with regard to business separation costs is:

- ◆ capital expenditure incurred by Transco's NTS and RDN businesses as a result of business separation will not be included in Ofgem's assessment of the overall allowed revenue for that business; and
- ◆ operating expenditure will be calculated in the ordinary manner. Distribution operating expenditure allowances will be set having regard to information made available through comparative regulation.

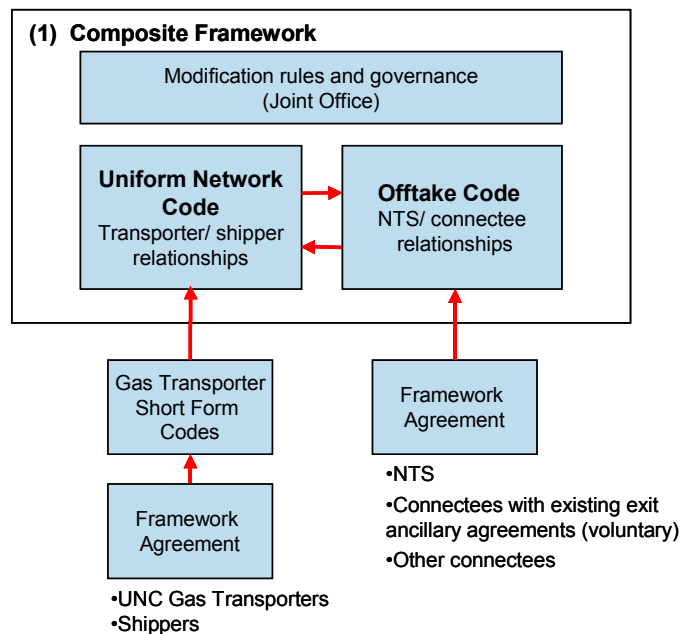
Governance

5.37. Given the Authority's conclusion to adopt an Option 2 approach to the offtake arrangements, we consider that further consideration is necessary regarding the appropriate governance arrangements for offtake. We consider that all interested parties should have the opportunity to participate in the governance arrangements.

Ofgem will therefore be considering these issues further through the workgroup meetings.

5.38. Transco has expressed concerns that there may be significant obstacles in DNs becoming signatories to the Network Code, at least in the short term. Transco argues that this approach would entail a significant reworking of the current Network Code to define additional contractual relationships between the NTS and the DNs, and would require an exemption to Section 5 of the Gas Act to allow DNs to make arrangements with the NTS for the offtake of gas. In response, Transco has proposed a new “composite” model for governance arrangements, illustrated in Figure 5.1 below.

Figure 5.1: Composite framework approach to governance



5.39. Under this “composite framework” proposal, the Network Code and the Offtake Code share a set of common governance arrangements. At the same time, however, the codes retain separate identities enabling the parties to the two codes to be separately defined, thus retaining clarity of purpose with the UNC defining the contractual relationships between shipper and GTs, and the Offtake Code defining contractual terms between the NTS and loads connected to the NTS. This arrangement would also provide for a common contractual relationship between the NTS and connectees (including DNs and NTS direct connects), thus potentially helping to address Ofgem’s concerns over the potential for undue discrimination between such parties. This framework also has the potential, combined with an

Option 2B NTS exit capacity model, to allay Transco's concerns that an exemption to Section 5 of the Gas Act would be required.

- 5.40. Whilst Transco's proposals potentially remove Ofgem's original concerns regarding the possibility of undue discrimination arising in the governance of NTS offtake arrangements, we consider it important to ensure that the model proposed by Transco does not preclude the possibility that shippers may be able to contract for NTS exit capacity directly from the NTS at some time in the future. The Authority therefore considers that it is appropriate to explore Transco's proposal further, and develop a detailed and satisfactory solution with Transco and through the workgroups.

6. Way forward

- 6.1. The Authority's conclusion document on the appropriate form and content of the offtake arrangements is a key step in creating a high level framework to support a divested industry structure¹⁵. Ofgem will discuss the Authority's conclusions on these issues at the DISG meeting to be held at Ofgem's offices on 17 August 2004.
- 6.2. Following the Authority's conclusions in favour of Option 2 for NTS exit capacity allocation, further work will now need to be undertaken to develop these arrangements to a more detailed business rules level. Further work will also be required on the development of appropriate incentives for the DNs.
- 6.3. On diurnal storage and operational flows, Ofgem intends to develop and discuss the proposed Option A* model with the workgroups over the coming month. These discussions will contribute to the development of a position paper that will outline the framework of arrangements to be included in the Final RIA.
- 6.4. As outlined in the previous chapter, the Authority is also minded to require Transco to undertake targeted structural separation of its NTS and RDN businesses, in combination with legal separation. The detail of how this separation will be implemented will be subject to further analysis and discussion in the workgroups. In addition, Ofgem notes that a number of the conclusions outlined in this document will need to be reflected in industry licences and codes (e.g. business separation conclusions are likely to require licence amendments). To this end, Ofgem will be conducting an informal licence consultation in early September.
- 6.5. Ofgem will now proceed to develop a Final RIA, which will consolidate the conclusions outlined in the four conclusion documents. This document, to be issued at the end of September 2004, will compare the status quo (i.e. a no sale scenario) to a fully developed post DN Sales environment (i.e. a sale scenario). The Authority will invite respondents' views to this Final RIA. These views will form part of the Authority's consideration when taking its decision in November on whether DN Sales should proceed. The Authority's decision will be based on an assessment of whether the proposed sale of DNs will protect the interests of customers. As

¹⁵ Note that, as stated more fully in paragraph 1.5, the Authority will not be fettered by any statements made in this document.

previously noted, therefore, nothing in this document fetters the Authority's discretion in considering whether to consent to a disposal of DN assets in November 2004.