DN Sales Development & Implementation Steering Group Minutes

Meeting 15

3 August 2004, 10:00 am – 2:00 pm

Ofgem's office, 9 Millbank

Attendees

Sonia Brown	Ofgem (chair)	Richard Street	Statoil UK
Mark Feather	Ofgem	Tory Hunter	SSE
Farook Khan	Ofgem	Rob McDonald	SSE
Hannah Cook	Ofgem	Martin Kinoulty	United Utilities
John Costa	EDF Energy	Sue Higgins	National Grid Transco
Steve Gordon	ScottishPower	Mike Ashworth	National Grid Transco
Charles Ruffell	RWE Npower	Peter Bingham	National Grid Transco
Mike Young	BGT	Alan Raper	National Grid Transco
Peter Bolitho	E.ON UK	Sebastian Eyre	Energywatch

1. Review of items from previous DISG meeting held 20 July 2004

a. Review of minutes

Mike Young requested that under section 8, the record of his comment could be amended to reflect his intended query and therefore read:

> "Mike Young asked if the proposed structure would adapt in the event of different sale scenarios"

b. Review of actions

The actions arising at the previous meeting had been discharged as follows:

- **Action:** *NGT to circulate list of methodologies contained in Network Code subsidiary documents to the group.* This action was carried over to DISG 16 with relevant documents to be provided to Ofgem by Friday 13 August.

- **Action:** *Ofgem to circulate position paper on pensions to the DISG.* The paper was circulated prior to the meeting. Tory Hunter asked whether Ofgem will be issuing another statement regarding under-recovery/shortfalls in relation to pensions. Sonia Brown responded that Ofgem has provided as much information as it can at present. She said that the discussion regarding pensions will continue to evolve in conjunction with the DPCR and Ofgem will gain more clarity regarding this area as the issues in relation to the DPCR are worked through. Therefore Ofgem are not expecting to issue any further information regarding pensions until the final proposals in relation to the DPCR are published in November 2004.

- **Action:** *NGT to test the proposed agency governance solution to different scenarios and consider if the proposed solution is workable.* NGT has sent a report to their executive committee and are currently awaiting its approval. Subject to the outcome from the executive NGT will report back to the DISG regarding the proposed solutions, with relevant documents to be provided to Ofgem by Friday 13 August.

2. Report from the workgroups

a. Report from the Commercial Interfaces Workgroup

Mark Feather reported that the CIWG had covered a range of topics. Transco gave a presentation regarding the definition of a firm product and the delivery of an exit capacity product. Most of the discussion on the presentation related to the creation of zones and how these should be defined in the context of Transco's transmission system. The slides presented by Transco suggested establishing exit zones at particular offtake points and this sparked a discussion regarding the trade-offs of having broader or narrower zones. The CIWG also ran through the outstanding areas on the issues log.

b. Report from the Supply Point Administration Workgroup

Mark Feather stated that the SPAWG are working towards a report for the next DISG meeting regarding conclusions in relation to the work on the matrix of ungoverned services. Richard Street stated that the report had been issued for comment and that responses had been requested by 4 August. He said that following consideration of any responses the report would be re-drafted and issued for approval.

3. Transco business rules for credit arrangements

Alan Raper delivered a presentation to the group in conjunction with his proposals paper regarding credit & terminations arrangements. He set out that, at present, the credit arrangements are handled by Transco but, following the potential sale of one or more DNs, individual DNs would have their own arrangements and that xoserve would be responsible for issuing invoices to relevant parties.

Alan detailed that there would not be a huge amount of change in the credit rules but that they would be modified to accommodate the increased number of trading partners. Under these arrangements, credit rules would be the responsibility of each Network Owner (NO) and in the event that a shipper breached its credit limit, following the application of certain sanctions e.g. depopulating a shipper's portfolio, the NO would have the ability to serve the user with a termination notice. Transco proposes that, as part of this termination process, the shipper would only be prohibited from using the network of the NO from which it was terminated and that it would not automatically be terminated from all networks to which it is connected. Alan stated that certain circumstances will still exist in which the user could be terminated from all networks. However, he said that, in most cases, it will be left to the discretion of the NO as to whether to terminate its contract with a certain shipper in accordance with the NO's own credit rules.

Sonia Brown commented that a particular concern that Ofgem had become aware of related to the possibility that shippers may choose to default on IDNs as opposed to RDNs. Sonia was under the impression that "one-out all-out" termination provisions had been discussed previously to address this concern. Alan Raper responded that the NO will have a credit chain in place allowing it to manage its own risk and in cases where it becomes apparent that a particular user appears to be a credit risk the NO will have the ability to apply sanctions in order to reduce its risk. Alan stated that the operation of a one-out all-out provision is a crude mechanism that takes discretion away from networks. Alan said that Transco has therefore proposed alternative measures that attempt to prevent the cascading of contract terminations across all networks.

Rob McDonald felt that the introduction of these new arrangements simply shifted risk to the individual DNs in that they would be responsible for making decisions regarding sanctions and terminations.

Sonia Brown suggested that IDNs could impose higher credit thresholds to address the problem that users may be more inclined to default on the IDNs as opposed to the RDNs. However, she stated that this may impose increased costs on shippers from having differing credit limits imposed by differing NOs. Sha said that some shippers had previously imposed the one-out all-out provision in an attempt to deal with this problem. Alan Raper responded that Transco had a preference to allow each DN business to manage its own risk.

Sonia Brown highlighted that, at present, Ofgem is undertaking a workstrand regarding credit policies and that it will therefore be necessary to ensure that the arrangements adopted are consistent with the outcome of this workstrand.

Alan Raper commented that he did not consider the one-out all-out provision to be a good principle to adopt as if one DN decides to issue a termination notice this will require that all DNs terminate the shipper and this therefore removes the discretion that currently exists within the Network Code. John Costa commented that the disconnection of users by the EBBC would involve a degree of discretion and yet allows the disconnection of all users from the network in a similar way to the one-out all-out principle. Charles Ruffell considered that this was largely a discussion about the allocation of transportation risk.

Sonia Brown commented that the group had previously come to the conclusion that shippers would have a preference to default on IDNs rather than RDNs and, in order to reduce the incentive, IDNs may be permitted to offer a higher credit level to users. She emphasised that Ofgem is aware of shipper concerns regarding this idea. Mike Young responded that arrangements of this kind may cause increased complexity for shippers with respect to credit management. However, if the incentive is there for shippers to default on the IDN system this creates risks for the DN and automatically makes the costs higher.

Sue Higgins commented that Transco anticipated that the one-out all-out provisions wouldn't work very well as DNs would not want to be responsible for the termination of a shipper from the whole network where it had defaulted on payment to only one DN. She stated that Transco were therefore looking into different ways to make the existing arrangements work following a potential DN sale. Alan Raper supported this comment and stated that Transco were simply attempting to implement a strategy which would mitigate risk for all parties involved.

Sonia Brown highlighted that Transco's approach to credit management had changed. She stated that it appeared that Transco had reverted to the proposals that they had initially put forward and were now of the opinion that the RDNs and the IDNs would be permitted to have different credit limits. Mike Ashworth responded that the arrangements were essentially driven by the decision regarding business separation and whether the NTS and RDNs were to become separate legal entities. Sonia Brown agreed that the discussion regarding business separation is important with respect to this issue as some members of the workgroups had continued concerns that shippers would treat RDNs differently from IDNs.

Rob McDonald suggested that each DN should have its own credit arrangements that are consistent with a set of common credit principles. He considered that a DN should make decisions regarding the termination of user contracts in keeping with the principles and that it should be able to justify that it acted reasonably in such situations by reference to these principles. In response Mike Ashworth pointed out that termination of a contract is not always such a clean-cut issue and that a dialogue will take place prior to the issue of a termination.

Sonia Brown commented that the one-out all-out provision was considered as a result of concerns raised by shippers. In the current environment, where a shipper goes into default this is dealt with by Transco and that following a potential DN sale it would be preferable to maintain consistency in terms of credit arrangements across all DNs. Rob McDonald supported this citing that if each DN has a common set of rules and these are applied consistently then scope for discrimination only exists where DNs consider terminating contracts with shippers. Tory Hunter also considered that any network which operates a one-out all-out policy has the potential for discrimination.

Alan Raper stated that under the arrangements proposed, where a user defaults, termination of the contract is a discretionary action and this allows defaults and subsequent terminations to be kept within the local area. Transco considers that the operation of a one-out all-out policy may cause some DNs to be dragged into acting on something which is not of their own making.

Sonia Brown stated that it was particularly important to get shippers' views regarding:

- any incentives that exist to default on IDNs as opposed to RDNs;
- the difference that would be made to these incentives if Transco was required to separate out its NTS and the RDNs.

Martin Kinoulty responded that there is an incentive to default on IDNs as opposed to RDNs and that this would be mitigated if Transco was required to separate its business. Charles Ruffell echoed this view and considered that the issue of Transco's business separation needed to be addressed. Rob McDonald stated that if Transco does not separate its business then it is likely that the incentive will still exist.

A general agreement was reached that the incentive issue does exist. In response to this Alan Raper commented that shippers will look at which service provider they have the smallest portfolio with when taking a decision on which they should default to. Mike Young supported this argument stating that users of the system would choose to pay the NTS first, as if they cannot operate on the NTS they will not be able to employ the services of DNs either. Peter Bolitho supported this, citing that if an RDN remains linked to the operation of the NTS, a shipper would choose to clear its debts with the RDN before it pays IDNs in order that it continues to receive a service from the NTS.

Richard Street argued that a system in which credit limits varied between DNs would require companies to sign up to a regime where shippers could potentially be in breach on some networks where they would not be on others. He stated that the policies to which individual networks intended to adhere should be clear and transparent in order to avoid any confusion amongst users.

John Costa pointed out that even with a set of general principles, there would still however remain a degree of discretion in relation to the termination of contracts. Sue

Higgins had further concerns that if this were the case and individual DNs had their own interpretation of the rules then this would make things more complex again. Peter Bolitho however was of the opinion that as termination would be the final stage in the process it would require significant consideration by the DN and therefore an element of discretion is unavoidable.

Sonia Brown asked the group how any incentive to default on IDNs as opposed to RDNs should be addressed if it exists. She asked whether Ofgem should simply accept that it is present and therefore allow IDNs to pass through increased debt from shippers. Richard Street responded by suggesting that separate roles should exist between RDNs and the NTS to remove this incentive. Sonia Brown clarified this by asking whether if the RDNs existed as one company this would make shippers reluctant to default on any of them. Richard Street responded that this is simply a commercial reality.

Sonia Brown stated that responses to the Agency and Governance RIA had highlighted that an arrangement in which individual DNs would have different credit arrangements would be a big issue for shippers as users of the system. She asked whether shippers would be happy with DNs having differing credit arrangements.

Rob McDonald reiterated that a common set of rules regarding credit arrangements should be implemented. Mike Ashworth responded to this and asked what exactly this would mean. Rob McDonald considered that a common set of rules would be consistent with the approach that Ofgem is currently working towards within its credit workgroup. Sonia Brown pointed out that the workgroup is only currently working towards achieving a common set of principles and the application of these principles by individual DNs will produce varying results. Sonia also stated that the imposition of different credit rules by each DN would contribute to a credit monitoring issue for shippers and asked the relevant shippers in the group whether this would have an effect on costs.

Peter Bolitho commented that the effects wouldn't be the same for all users. He considered that for larger shippers with better credit ratings, costs could actually fall while for smaller players the associated costs may be more significant. Sebastian Eyre was of the opinion that the costs would depend upon the portfolio of the shipper i.e. if the shipper had a greater number of I&C customers then it would more likely have a good credit rating.

Peter Bolitho was of the opinion that if DNs adopted a common set of rules in relation to credit arrangements (with some differences dependent on their interpretation), then it is likely that when shippers experienced difficulties these would generally cause them to default on each network at a similar time. Rob McDonald considered that differences in approach regarding credit arrangements would lead to an increase in costs for shippers. Sonia Brown responded that work from the gas forum had not highlighted this as a key problem but that responses from the Agency & Governance RIA highlighted that the majority of shippers had concerns about credit arrangements.

Sonia Brown considered that gas shippers should present the proposals regarding credit arrangements to the gas forum for discussion and report back on any conclusions reached to the next DISG.

Peter Bolitho asked the group whether the credit rules would be incorporated within the UNC or whether each DN would be subject to a separate set of rules contained within their Short Form Code (SFC). Alan Raper responded that the rules within the current Network Code would continue to exist and would be amended to provide each DN with the ability to modify these rules. Peter Bolitho queried further whether, following the amendments, certain sections of the Network Code would be ring fenced to the effect that they could no longer be modified through existing modification rules. Sonia Brown responded that the modification processes would continue to apply to these sections of the Network Code, although it is likely that these rules will appear in SFCs as opposed to the UNC. Mike Ashworth pointed out that at present the code credit rules are published but are not modifiable and that following a potential DN sale it should become possible to amend these rules but not by the parties that incur the debt i.e. shippers. Sonia Brown highlighted that any modification proposal would ultimately be decided by Ofgem and this would offer a safeguard to all parties involved.

4. Outline of shipper costs surveys

Sonia Brown gave a presentation on the proposed shipper costs surveys that Ofgem was intending to issue. In the presentation, she outlined that the overall RIA will present a status quo and alternative model post DN sales and that Ofgem wished to be able to determine final quantitative and qualitative costs and provide the Authority with a view on the overall costs and benefits of a sale in November. Ofgem are therefore trying to collate overall costs within the industry in order to establish the efficient level of costs. The shipper pro forma questionnaire will contain a straw man of the commercial and regulatory framework post DN sales and Ofgem would like companies to provide details of the costs that they envisage they will incur under this framework.

John Costa asked whether 16 August was the earliest date that Ofgem could send the pro formas out as a lot of people will be on holiday around that time. Sonia Brown responded that it was and that Ofgem has given shippers plenty of notice to ensure that they can organise the necessary resources to complete the pro forma.

Richard Street asked how big the pro forma will be. Sonia Brown responded that it will request data in relation to specific cost levels and will incorporate explanatory boxes associated with the cost levels. These explanatory boxes will enable Ofgem to analyse the data making allowances for certain assumptions.

Sonia asked the group if anybody wished to volunteer to assist in the completion of the shipper pro formas. She requested that any such shippers let her know if they wished to volunteer.

5. Ofgem position paper on the governance of changes to the distribution charging methodology

Mark Feather established that this issue had been ongoing and that he was going to set down Ofgem's views in relation to governance of changes to the distribution charging methodology. He clarified that this did not fetter the Authority's decision with regard to any decisions made in the future.

The Governance & Agency RIA was released in April 2004 and issues discussed within this paper included governance arrangements and charging methodologies. The paper concluded that an independent governance entity should be established to administer changes to the Network Code and charging methodologies.

A number of issues remained with respect to these:

- Should all DNs be required to make consistent changes to their methodologies at the same time?
- Should charging methodology objectives be changed?
- Will Ofgem consider the costs of potential divergence in assessing changes to charging methodologies?
- Should changes to NTS charging methodology be managed by IGE?
- Frequency of changes and revenue forecast information.

Mark Feather explained that Ofgem had reached an informal view regarding these issues and had taken into account the experience of the electricity industry.

Mark indicated that any requirement to amend charging methodologies simultaneously or make them consistent may stifle any such innovation generated by comparative regulation and may also prove difficult to enforce in practice.

Mark stated that Ofgem considers that the NTS methodology should continue to be captured by the Independent Governance Entity (IGE). If the IGE deals with the charging methodologies for both the NTS and the DNs this will remove any scope for discrimination and may help to ensure transparency in relation to any change to the charging methodologies. Mark indicated that Ofgem did not envisage proposing changes to the charging methodology objectives to address the costs or impact of fragmentation. However, he stated that Ofgem would need to examine more closely any impact that divergence of the charging methodologies may have on retail competition in assessing any change proposals.

With respect to the issue of frequency of changes to the charging methodologies, Ofgem wants to provide some certainty to the industry with respect to charging arrangements and to this end intends to place an obligation on DNs to use reasonable endeavours to only change their charging methodologies on a specified date, once a year.

Mark Feather set out further that Ofgem intended to conduct an informal licence consultation early in September 2004. He stated that Ofgem envisages that, in order to address the introduction of a governance entity, a number of changes to SLC 4A of the gas transporters licence will be proposed.

Richard Street asked whether, when filling in the shipper pro formas, the approach detailed by Ofgem should be considered an assumption. Sonia responded that shippers should use this as an assumption. Mike Young pointed out that shippers would have to incorporate flexibility within their systems in order to deal with changes to the charging methodology.

Peter Bingham indicated that most DNs seemed to have an interest in maintaining a degree of consistency between the charging methodologies and would therefore be keen to make relevant changes at the same time. Sonia Brown responded by stating that the level of costs that a shipper would incur would be dependent on whether the DN was interested in pursuing innovative ideas or maintaining consistency. Sonia added that Ofgem is interested in seeing what the costs to shippers of changes in charging methodologies would actually be so that each scenario can be evaluated. Ofgem would therefore appreciate as much information of this nature that can be provided.

Rob McDonald indicated that DN sales may serve to increase the range of issues that shippers encounter especially with reference to the divergence of charging methodologies. He stated that he favoured the idea of retaining a degree of stability in relation to any changes to be made to the charging methodologies and considered that predictability in this respect would be important. Mike Young perceived that if DNs were only permitted to amend their charges once a year it would allow shippers to prepare for this.

Sonia Brown detailed that Ofgem is simply trying to produce a more ordered process. She also stated that Ofgem consider that this is a DN sales issue as problems may arise for shippers if each of the DNs and Transco decide to regularly make changes to their charging methodologies.

Mike Ashworth enquired as to what Ofgem meant by the use of the phrase reasonable endeavours. Sonia Brown responded that if DNs were to change their charges more than once in the period of a year, they would need to have an appropriate reason for doing this.

Peter Bolitho considered that if a certain DN devised a positive innovation with respect to the charging methodologies then it should be adopted across all of the DNs. In this respect he was of the opinion that a mechanism should be in place to ensure that good practice is followed in relation to changes implemented within charging methodologies. Sonia Brown responded that as all things in gas are managed centrally, any changes to the charging methodologies will be undertaken through a centralised process which will ensure that all industry parties are aware of the modifications. In this respect, if shippers consider that a modification implemented by a certain DN is particularly innovative they will have the ability to exert pressure upon other DNs to amend their charging methodologies. Sonia expanded on this stating that Ofgem can also act as a backstop to ensure that DNs review all aspects of their charging methodologies.

Sue Higgins asked how Ofgem perceived that changes to DN charging methodologies would operate in practise. Sonia Brown replied that Ofgem will keep the charging methodologies under review.

Peter Bingham suggested that allowing DNs to change their charging methodologies twice a year may be more appropriate to allow DNs to manage changes in the weather more effectively. Richard Street pointed out that consumers do not like the fact that gas prices change so regularly.

Rob McDonald stated that he did not have any problem with the process proposed. He stated his major concern related to stability. Sonia Brown encouraged all participants to submit their views on these matters in their responses to the informal licence consultation.

6. Constitution of the governance entity

It was decided that, due to time constraints, DISG members would take away the papers associated with the constitution of the governance entity and that it would be discussed at DISG 16 on 17 August.

7. Review of the DISG issues log

A number of changes to the issues log were made. An updated version of the issues log is attached to these minutes. Sonia Brown stated that the issues that remain open hinge largely on the outcome of the interruptions and offtake arrangements RIA and once these decisions have been taken many of the issues can be closed off.

Sonia Brown also stated that if DISG members are aware of any issues which haven't been included in the log they should make the DN sales team aware so that they can be included.

8. Transco paper on current price control treatment of shrinkage

Sonia Brown requested that DISG members read the NGT paper on shrinkage and inform NGT of any outstanding issues. NGT should then report back to the group at DISG 16.

9. Any other business

Tory Hunter enquired as to whether Ofgem intended to take any further action with respect to the pension's paper. Sonia Brown responded that Ofgem was not looking for any feedback on this particular topic but would be happy to provide clarification in any areas where it is required.