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Dear Sonia

Initial thoughts on restructuring of Transco plc's Gas Transporter Licences – Consultation document 215/04

Thank you for giving us the opportunity to comment on the above consultation.

As a major shipper-supplier E.ON UK's main aim is to assist Ofgem in its establishment of coherent, consistent gas transportation licencing arrangements that help prevent fragmentation of existing market rules, charging arrangements processes and systems. Our response therefore concentrates on these aspects rather than matters that are rightly issues between transporters or Ofgem and individual licencees. For convenience we firstly set out our general views in relation the proposed new licence framework and key issues (chapters 3 and 4) and secondly detailed comments on specific licence conditions (chapters 5 and 6).

Restructuring Transco's GT Licences

The Ofgem proposals seem to be designed to work 'within' the existing regulatory frameworks rather than completely restructure the gas transporter licencing regime (e.g. into transmission and distribution licences). We understood the later would almost certainly have required primary legislation. Ofgem's approach may allow the DN sales process to proceed more quickly but will make the regime unnecessarily complex and less transparent than it might otherwise have been.

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Although Ofgem broadly speaking appear to be seeking to preserve the collective and individual safeguards for proposed licence changes that exist under Transco's current licence, the new categories of licence condition are confusing. As a result the processes for future changes to the new licences could become unnecessarily costly and bureaucratic, compared to current arrangements.

In particular, the legality of the so-called private CLM procedure, which is an integral and indeed critical element of the overall proposals, is questionable. Ofgem states that it is able to introduce such a procedure pursuant to section 7B(7)(b) of the Gas Act 1995 (footnote at the bottom of page 20 of the consultation), thus avoiding the need for a true statutory procedure. 7B(7) (b) however, is tightly drafted and would seem to be drafted to not allow "self modification" unless such "self-modification" spells out the detailed policy objective in the proposed licence change.

Given these uncertainties in legal interpretation we would urge Ofgem to set out in detail why it considers it is legitimate to introduce the private CLM procedure under section 7B (7)(b) of the Gas Act 1995.

Key Issues

Transportation charging arrangements

We welcome Ofgem's proposals which are designed to mitigate against inefficient fragmentation of the distribution charging arrangements, including the establishment of a Joint Office (JO) to co-ordinate proposed changes across the industry and a reasonable endeavours obligation on transporters to make changes to charges on one specific change each year. We support the necessary changes to transportation licences to facilitate these proposals.

Nevertheless we consider that it is ultimately the form and degree of independence of the Joint Office that will ultimately influence how successfully transporters will meet these new licence obligations. An adequately resourced Joint Office organisation managed at arms length from Transco run for the benefit of users and other stakeholders as well as transporters is vital.

Emergency services coordination

The proposals outlined appear to be reasonable. Nevertheless we understand IGTs wish to see the existing emergency and repair service arrangements that are currently provided by Transco, under contracts which are due to lapse shortly, continued into the foreseeable future. It would seem that in practice it is not feasible or desirable to make the emergency or indeed the repair service contestable. We look forward to IGTs, Transco and potential DN buyers agreeing new arrangements, on similar terms to the current Transco arrangements.

System operator managed services agreements (SOMSAs)

We had previously expressed concern about the transparency of these arrangements, and the scope for Transco as NTS system operator to discriminate between DNs. Under the previous Roles and Responsibilities consultation we considered that Option 3 (the hybrid approach) provided a more accurate description of the split of activities, i.e. who will actually do what on day 1 post DN sales. Furthermore we considered that the main difference between Option 1 and Option 3 was that certain responsibilities were simply contracted back to Transco under a SOMSA (i.e. Option 1 + SOMSA = Option 3).

Transco are currently in the process of centralising many DN level SOMSA activities at Hinckley. In addition it is not clear that the new DN owners necessarily wish to necessarily take such activities in house. If as a result SOMSAs were to persist for a long time (which may well be desirable as this may help reduce the motivation of new DN owners to seek to inefficiently fragment the arrangements) the lack of transparency and regulatory scrutiny may raise concerns as to the potential for discrimination between DNs. We would therefore prefer to see the standard form SOMSA terms defined as an integral part of the offtake arrangements.

Network Code and offtake arrangements

Earlier this year E.ON UK (as Powergen) set out a vision of a Transco led post DN sales world in which the existing Network Code would be kept whole, new DN owners would concentrate on asset management activities and the Offtake Code would simply be an agreement with the IDNs to enable Transco to procure transportation services for shippers in particular LDZs. In such a world IDNs would not have been party to the Network Code and shippers would not have been party to the Offtake Code (a similar concept to the BETTA arrangements in Scotland where Transmission Owners (TOs) contract with NGT as the System Operator (SO) under the SO-TO Code but are not party to the 'user-facing' codes (i.e. the GB Balancing and Settlement (BSC) and GB Connection and Use of System Code (CUSC)).

If this Transco led vision had been adopted for DN sales it would have been perfectly reasonable for the Offtake Code simply to be a bilateral contract. Instead it is proposed to establish a multi-transporter to multi-shipper Uniform Network Code (UNC) in which the offtake arrangements form an integral part of the delivery of transportation services to shippers. Thus the offtake terms must come under the governance of the UNC process – changes might otherwise emerge from bilateral arrangements between transporters which may undermine the integrity of the primary end-to-end 'beach to meter' transportation service provided to shippers.

By way of illustration end-to-end 'beach to meter' transportation services provided by Transco to shippers are already weakened by inadequate arrangements set out in existing bilaterally 'negotiated' agreements. IGT Connected System Exit Point Network Exit Agreements (CSEP NExAs) are loosely subject to Network Code governance in that changes must be made to such agreements to make them consistent with any Network Code changes. These agreements have nevertheless prevented Transco from properly fulfilling obligations with respect to energy allocations under the Network Code. This

reduces the quality of service shipper-suppliers are able to provide to its IGT connected customers.

The consultation document focuses on a UNC only or a UNC plus offtake code approach; although both would be subject to the same overarching governance arrangements. Our preference is for the UNC only approach as this is most likely to maintain the integrity of the existing end-to-end Network Code arrangements. The industry already suffers from a proliferation of codes, methodologies, statements and guidelines each of which form part of the overall gas trading arrangements. Separate documents would add to this bureaucracy and might provide a vehicle for the future decoupling of the NTS offtake arrangements from the overarching national governance arrangements.

Ofgem's latest proposals with regard to exit reform and particularly the intention to subject both DNs and NTS direct connects to new arrangements introduces the possibility that NTS direct connects will be subject to equivalent offtake terms. This in itself shifts the Offtake Code from being merely a transporter 'interface' agreement to one in which its terms become crucial to the service provided to end-users. We also do not believe end-users connected to the NTS (as opposed to end-users connected within a DN) will take kindly to being required to enter into offtake agreements with Transco. End-users would only enter such agreements if they perceived such agreements offered added value – we would suggest that complex terms dealing with within-day flexibility, firm, and less firm rights are unlikely to be considered a positive step forward. The default expectation would be for the rights and obligations for the offtake of gas to remain firstly with shippers. Of course this doesn't preclude different services or direct relationships between transporters and end-users emerging in future, but we do not believe the Offtake Code (which essentially forms part of the end-to-end transportation service to shippers) is the right vehicle for that.

Shippers and end-users will want to ensure maximum transparency and consistency in the offtake arrangements and we consider this is best achieved by ensuring offtake terms are an integral part of the UNC. This in turn will reduce the potential for discrimination between NTS connectees. The Network Code after all was about creating standardised terms in which the competitive market in shipping an supply could emerge – the industry should think very carefully before fragmenting these standardised arrangements.

Pricing controls and incentive arrangements

We support Ofgem's approach to avoid reopening Transco's existing price control. We would urge Ofgem in looking at new supplemental incentive arrangements to avoid establishing unduly complex arrangements which are difficult for market participants to understand. Judging whether these schemes represent true value for money is always difficult, but shippers and in turn customers from which the allowed revenue is ultimately recovered need to know their money is being well spent.

Pipeline security standards

We consider that the 1 in 20 security standards should continue to apply to both the NTS and DNs. To limit these arrangements to the DNs would potential lead to the degradation of service to NTS direct connects. There is no objective reason why customers that happen be connected to the NTS as opposed to similar sized customers that are connected within a DN should potentially be unduly discriminated against in this way.

Licence Conditions

In most cases we are happy with the form of proposed licence conditions, although not necessarily with the mechanism proposed for their introduction. Comments are therefore made below on an exception basis.

Part A

Amended Standard Condition 1 – Definitions and interpretation

The mechanism of the section 23 notice through which Ofgem proposes to redefine the licence classifications, may go beyond the intent on section 7B (7)(b) which is tightly drawn. We would urge Ofgem to clarify why it believes the mechanism by which it proposes to introduce new licence classes and modification procedures is permitted under the Gas Act.

Part B

Amended Standard 4 – Charging Gas Shippers – General

We support the introduction of new licence conditions regarding the frequency of changes to charges and co-ordination of proposed amendments by the Joint Office. The specified date for changes should be the 1 October, i.e. the start of the gas year. Annual contracting rounds with I&C customers and long-term gas purchasing agreements with producers are typically based on the gas year. Licencees may well press for alignment of charging changes with the price control year (April to March). This has always been resisted by shippers and customers alike.

As regard to LNG Storage arrangements these should be considered to be part NTS transportation arrangements. As DNs receive small amounts of boil off gas into their systems it is important that this is properly accounted for. Such accounting arrangements should form part of the offtake terms set out under the UNC. Although such flows are trivial at the current time it is important the industry has visibility of these arrangements as similar but larger boil off quantities will be required for future LNG import terminals

Amended Standard Condition 4E – Requirement to enter into Transportation Arrangements in conformity with the Network Code

We support the requirement on licencees to enter into arrangements in accordance with the UNC. Nevertheless we understand that short-form codes will still coexist with the UNC. Our concern is to prevent any change to these short form codes without reference

to the central national UNC modification rules. We therefore believe it would be appropriate to introduce an obligation to require licencees to ensure that any changes to gas transportation arrangements are subject only to the change procedures set out in the UNC modification rules.

As we consider that it is best to include the offtake terms in the main UNC document and shippers and transporters will be subject to that code there is no need for an obligation on the NTS and DN licencees to accede to and comply with any offtake code arrangements.

Amended Standard condition 6 – Emergency Services and Enquiry Service Obligations

Given the new split of ownership of network assets we believe it would be useful to assign first line emergency response to each licencee on a geographical basis, thus relevant DNs could be required to provide support for IGTs and the NTS within their area. If required these obligations could extend beyond the boundaries of a given DN to provide a support role to the adjacent DNs

The current 'one company' communication arrangements that ensure the activities of engineers on the ground are co-ordinated will be broken with a split of ownership of transportation assets. Formal hand-over communications between transporters will be important, to maintain a quick response to and rectification of supply problems.

We therefore believe there should be an obligation on the transporter that provides the first line emergency response to promptly notify (ideally within one hour of the identification of a problem) the relevant network owner so that arrangements can be made to complete any necessary repairs and keep shipper-supplier and customers informed.

Amended Standard condition 8 – Provision and Return of meters, and Amended Standard Condition 29 – Disposal of Assets

The ownership of meters does not form part of the DN sales process. Nevertheless DNOs will have meter of last resort obligations and as such will acquire metering assets. We believe licence safeguards should be in place under Condition 29 so that DNOs would have to gain Ofgem's prior permission for the future disposal of these metering assets.

Suppliers face significant costs in terms of new system interfaces and data integrity with any change of meter ownership and at the very least we would wish to see any change of ownership being managed in a controlled way.

Amended Standard Condition 9 – Network Code

See comments under Condition 4E above, particularly making sure that all transportation arrangements whether they are on the NTS or with DNs are subject to the Network Code modification rules.

We also support the inclusion of a new relevant code objective focused on promoting “efficiency in the implementation and administration of the arrangements” which we take to include the activities of the agent (xoserve) and the new Joint Office. We also consider that Ofgem’s proposal to set out the scope of the agency within the Network Code is another essential safeguard for users, so that if necessary changes to these arrangements can be proposed. This is particularly important given that the transporters own xoserve and corporate governance arrangements being established ensure that this organisation is run for the benefit of the transporters. Many processes run by xoserve have a critical impact on the quality of service shipper-suppliers can provide to customers – we would therefore welcome a specific licence obligation requiring Transco to properly scope out the agency functions within the UNC.

Standard Condition 16 – Pipeline System Security Standards

As stated previously we support Ofgem’s view that there should effectively be no change to these obligations. Nevertheless we fail to see that any short term allocation arrangements that require NTS connectees to effectively compete with DNOs for a finite level of firm capacity could be considered to be consistent with the obligation to meet a 1 in 20 peak daily demand. In such circumstances existing firm NTS connectees users may in the short-term lose ‘rights’ they thought were assured by the 1 in 20 obligation.

Amended Standard Condition 25 – Long Term development Statement

The Transco 10 statement provides an extremely useful coordinated view on GB gas supply-demand balance and the need for development of the high pressure transmission systems. We do not believe it would be desirable to fragment this. Our preference is for Transco to continue to provide a single coordinated statement, in which case an obligation needs to be placed on DNs to cooperate with Transco in the preparation of this national statement. The existing standard condition should not apply to DNs.

Special Condition 26 – Prohibited procurement activities

In developing these conditions we believe it is important to base any restrictions on clear definitions of energy balancing actions necessary for Transco as residual energy balancer to maintain the overall supply demand balance on the overall system, and those system balance actions that relate to localised constraint management. It is imperative to avoid confusion between these activities and in particular preclude DNs from engaging in energy transactions, to prevent distortions to or fragmentation of spot gas markets. The trading arrangements are designed to financially incentivise shippers to energy balance, with Transco intervention only where necessarily. The DNs role must be carefully controlled to prevent them destabilising these arrangements.

Special Condition 27 Licencee’s procurement and use of system management services

There may be merit in an obligation on licencees not to prejudice the operation of each others’ systems. However, the drafting of this clause is so broadly drafted as to leave it open to wide regulatory interpretation. Something that is more specific may provide greater practical guidance and safeguards for licencees.

New licence conditions

Private CLM procedure

We understand why Ofgem is trying to adapt the existing licencing to the post DN sales world. We also understand the need to establish a collective process for modification to a relevant class of licencees. Surely however, the replacement of the statutory CLM procedure with a new arrangement requires a statutory process. The whole concept of a licence having “private” and “collective” characteristics seems somewhat confusing. Rather than introduce this new private CLM process now, would it not be better just to accept that inflexibility associated with individual consent, until such a new revised statutory CLM procedure can be introduced.

Switch on/Switch off

We are unsure as to the legal basis for this proposal under section 7(B)(7)(a) of the Gas Act.

Implementation of gateway requirements

It will be important to clearly set out the roles and responsibilities between the NTS and DNs. As stated earlier our main concern is to establish robust licence conditions to prevent DNOs taking energy balancing actions or being involved in speculative trading of energy.

We also consider that a licence condition requiring transporters to use a common agent with respect to all central settlement activities (as set out under Option C of Ofgem’s Agency and Governance regulatory impact assessment) is appropriate. If each of these activities is properly defined under the UNC, the licence condition could then make reference to the common agent activities set out in the UNC. We understand the xoserve contract could theoretically allow transporters to unilaterally opt out of these common arrangements after five years. A licence condition mandating use of a common agent ensures that Ofgem will be required to positively decide to disapply such a condition before such unilateral action could take place.

In regard to the offtake and interruptions arrangements any licence conditions should be limited to the arrangements necessary to establish the new arrangements on day 1. In our view it would be inappropriate to impose any licence conditions on licencees with regard to ongoing further reform, for example of the offtake and interruptions regime within the DNs. Ofgem has indicated that such further reforms will be subject to a separate regulatory impact assessment at the time. It is therefore follows that further reform should be considered as a stand-alone project and be decoupled from the main project thus making licence obligations mandating licencees to promote further change unnecessary. Certain reforms are either part of the DN sales project or they are not – if they are, full consideration, of such reforms should be included in the overall DN sales regulatory impact assessment.

Requirement not to prejudice the system if other GTs

As stated earlier these broadly defined clauses may be useful in to at the very least set an aspiration to work together with other GTs rather than pursue individual narrow interests. If these terms are to be introduced it would seem sensible to extend such obligations to IGTs. This might help bridge some of the inadequate contractual arrangements in the IGT CSEP NExAs, which can at times undermine Transco's ability to meet its obligations to shippers under the Network Code with respect to energy allocations (impacts the efficiency of Transco's processes) which ultimately affects the quality of service provided by shipper-suppliers to their IGT connected customers.

Inter-operator service agreements (including SOMSAs)

We agree with the criteria Ofgem has established to decide whether these agreements are regulated or not, namely whether the service is a monopoly or a contestable service and/or whether the service is transitional or enduring.

Nevertheless we believe Ofgem should for the sake of service continuity of service and safety adopt a cautious approach in establishing their views on contestability and transitional arrangements. First line emergency response services and emergency contact details should in our view be regulated. We also anticipate that many other inter-operator service agreements (including SOMSAs) will persist for longer than Ofgem perhaps anticipate. In our view in seeking to justify the purchase price for the networks and the need to meet tougher future regulatory price controls buyers will firstly focus on the most material costs savings that can be achieved. These are likely to be primarily in relation to asset management and synergies with any wires/water businesses they own, not in relation to SOMSAs and similar agreements.

Thus regulatory oversight of many of these agreements may be still be warranted if only to ensure that there is not discrimination by Transco in the treatment of RDNs compared to IDNs. Equally it will be important to ensure that these services are not cross-subsidised by Transco's regulated activities. In relation to SOMSAs our preference is for these terms to be regulated and also to form an integral part of the NTS-DN offtake terms under the UNC.

Governance of technical standards

Inefficient fragmentation of elements of the competitive gas market is a key concern for shippers. We therefore support a new licence condition applying to DN-GTs concerning the governance of technical standards under the UNC. Detailed arrangements would be set out in the UNC and unlike modification procedures for commercial rules these standards would not require the approval of the Authority.

Arrangement for testing measuring equipment at the NTS/DN interface

We agree with Ofgem's justification for proposing a new licence condition that relates to the testing of measuring equipment at the NTS-DN interface. This will also be required to ensure that flows at all NTS offtakes, i.e. NTS direct connects and DN offtakes are both subject to accurate measurement. This will be important in ensuring there is no undue discrimination between NTS connectees in relation to capacity or within-day flexibility services that may emerge.

We trust you find the above comments useful. If you wish to discuss any of the views outlined in our response please do not hesitate to contact me on the number at the head of this letter.

Yours sincerely,

Peter Bolitho
Trading Arrangements Manager