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Date 20th December 2004

Dear Sonia

Title: DN Sales – Final Impact Assessment

EDF Energy welcomes the opportunity to comment on Ofgem's detailed Final Impact Assessment (IA) on the sale of Transco's Distribution Network (DN) businesses.

We do not dissent from the view that a sale of the DNs under appropriate conditions should in principle be in the interests of consumers. It seems likely (and evident from the valuations being placed on the DNs by the buyers) that the first change of ownership of the DNs will lead to the identification of significant savings. In due course, these are likely to find their way to customers following future price control reviews and be spread to the retained DNs by comparative regulation.

However, there are two important caveats which would need to be addressed before we could support the DN sale process:

- (a) we would look for some assurance that a significant start is made in securing the benefits at the next price review. Customers will otherwise face "up front" costs incurred by shippers in facilitating the transaction long before they see the benefits. Furthermore, to the extent that shippers are unable to recover these costs from the market, an element of the gains should also be rebated as a lump sum to the affected shippers, rather than incorporated as part of the marginal cost of future sales. Otherwise, there is a prospect that shippers will be penalised for a deal done to benefit the DN sale parties. This would be inequitable; and

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- (b) we believe that a too ambitious and too hasty re-structuring of gas distribution regulation, in terms of both the licensing structure and exit reform, is being linked to the DN sale process. This could lead to both legal and practical problems, outlined below, that could negate the expected customer benefits.

The problem in licensing structure relates to the proposed “private standard” special conditions. There are good reasons to believe that this structure goes outside the powers in the Gas Act, which could leave the whole process open to challenge by a disaffected shipper, or ineffective if Ofgem’s rights to use the private standard mechanism of licence modification were later overturned – so leaving Ofgem with no collective modification powers in these cases. These matters are discussed in previous correspondence, so I shall not repeat them here.

On exit reform, it appears that Ofgem wishes to implement a large package of measures, affecting not only the relationships between the NTS and Retained DNs (RDNs) and the Independent DNs (IDNs), but also those between the NTS and directly connected loads. We believe that these measures go well beyond those necessary for the DN sales, and that they are being implemented with insufficient consideration. The proposals appear to be unfair as between DNs on the one hand and directly connected NTS loads on the other; they could also raise power prices.


It is simply too risky in terms of unintended consequences, for both the electricity and gas markets, to rush the exit reform package through on the commercial timescale for the DN sales, without the normal consideration of parties’ views inherent in the process of code modification. This is especially a concern since a thorough review in 2002 rejected similar proposals. We do not see how a transaction involving DNs should enable major changes too be made in the relationship between directly connected loads and the NTS without the due process to which Network Code parties are entitled.

Given the widespread concern about Ofgem’s proposals among shippers and power generators, we urge the Authority to de-couple the DN sales from the more contentious exit reform programme, so that the concerns of shippers can be properly addressed and worked through. A compromise might be for Ofgem to start with an approach based on grafting non-discrimination obligations onto the existing system and take some powers to implement exit reform at a later date, once the detailed design and the pros and cons had been adequately discussed with network users.

In summary, we are not against the concept of DN sales and believe they could be beneficial. But the risks involved in introducing the exit reform package without proper debate with the shipper community, combined with the legally unsound approach to licensing, mean we cannot support the current package. Ofgem’s RIA estimates the benefits to customers, over a 15 year period, as around £0.70 per customer per year. At this level of benefit, there is no justification for proceeding with undue haste or failing to consider fully the interests of affected parties. We would be happy to discuss with Ofgem how the package could be revised to gain our support.

Our detailed comments on Ofgem's consultation paper are attached. If you have any questions on this response please contact John Costa on 0207 752 2522 or myself.

Yours sincerely

A handwritten signature in black ink, appearing to read 'D. Linford', written over a light blue rectangular background.

Denis Linford
Director of Regulation

Attachment

EDF Energy's detailed comments on DN Sales – Final Impact Assessment

Evaluation of Impact Assessments

EDF Energy welcomes Ofgem's detailed comparison of views and assessments relating to the overall benefits in their report.

Although we are prepared to accept that the change of ownership process is likely to discover efficiency savings, these could be negated if the introduction of new arrangements without due consideration led to unintended consequences.

Furthermore, Ofgem is proposing extensive offtake reforms to control the inherent flexibility in the system which adds a new fixed and variable cost to current arrangements, costs which have not been precisely quantified through scenario planning, but merely qualified in Ofgem's final IA. This area seems to us to be one which, as presently proposed, causes considerable risks.

Present Value Calculation

In terms of calculating the present value of the potential costs to shippers, based on Ofgem's figures of £25m up front costs and on going costs of £7m per year for 18 years at a discounted rate of 6.25%, we have calculated total costs of £112m versus Ofgem's £95m. However, we recognise that the difference could come down to the way Ofgem has profiled its costs over the period.

Regarding the bell shaped profile of benefits, we understand Ofgem's rationale. However, in terms of how these benefits will be transposed into reductions to customer's bills, we believe a different profile will arise. We believe that the impact on customers' prices will take on a different profile, with costs being loaded upfront – see figure 1. This is because a significant part of the costs the industry will absorb as a result of the sale going through will be passed on, upfront, to protect retailers' gross margins. A proportion of shippers' initial costs are however likely to be unrecovered, in the absence of compensating measures. While this may slightly increase customer benefits, it is unfair for shippers to be penalised as a result of a transaction carried out for the benefit of the DN sale parties.

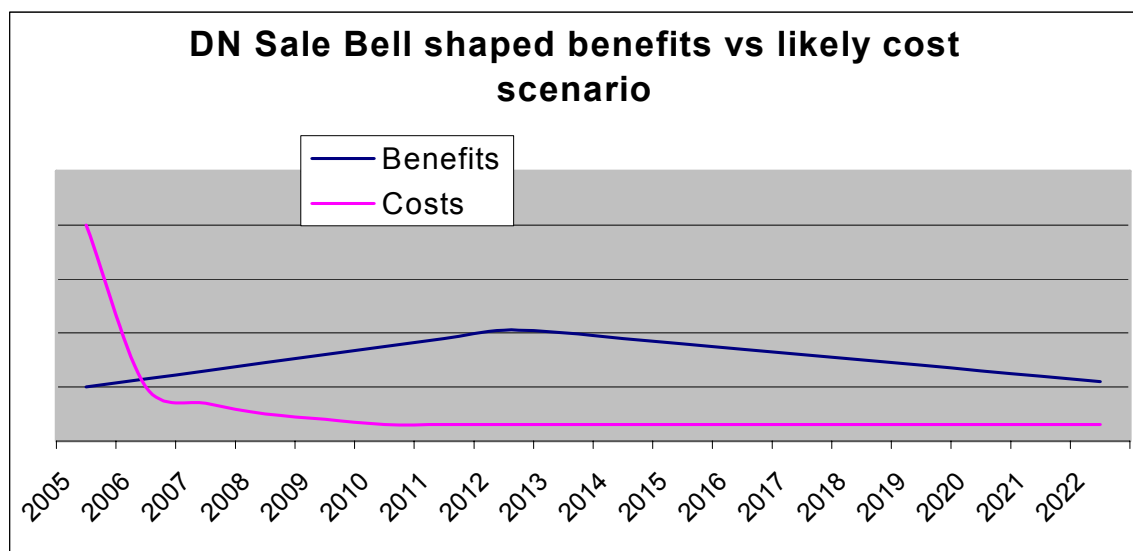


Figure 1

Therefore, customers will absorb much of the direct impact of any sale initially but the greater benefits Ofgem may introduce in future price controls will be subject to much greater uncertainty because by that time the industry may have restructured yet again – or the customer may apply a higher discount rate than Ofgem has assumed. For example, if Transco sells more of its RDNs or if the industry undergoes further consolidation, then some of these benefits will be lost in the process. This appears to receive some support from Ofgem’s comments in para 10.18 of their document that prices are dynamic and may go up or down in a competitive retail market. Given that Ofgem’s primary statutory duty is to protect customers’ interests, we would welcome Ofgem’s view on this issue and how the long-term customer benefits can be protected.

For this reason, we would like to see some assurance of early action to make a start on returning benefits to both customers and the shipper industry.

DN Sale Process and Governance Issues

EDF Energy is concerned about the way Ofgem has managed the DN Sale process. We are particularly concerned as a Shipper that due process has not been followed when turning the existing Network Code (NWC) into the UNC and with the development of Exit and offtake rules outside the code in the ad-hoc formation of UNC and Exit Reform Groups.

The NWC rules and procedures are there specifically to deal with industry reform yet Transco has chosen to circumvent them in lieu of a less robust form of change management where there is little control over policy direction. We also note the high pace of change that has been driven by Ofgem’s and Transco’s desire to push the sale through. This haste has been detrimental to the process. It could cause more cost to arise if industry either does not fully understand the details or is not ready in time for implementation should the sale go through. We recommend that Ofgem include a contingency cost figure for this event in their assumptions.

The NWC is the shippers' current contract with Transco and we do not feel comfortable signing a new agreement which was formed outside the auspices of our current contract. This is particularly an issue for directly connected NTS loads who are proposed to face significant changes in their contractual terms, without their contractually due safeguards, in order to facilitate a DN transaction in which they have no interest.

Regarding NTS Exit Reform policy, this is an area which the industry, together with Transco, have been developing over the last three years, culminating in Transco forming two work groups to develop both NTS Exit capacity profiling and scheduling charges and the universal firm regime, which Ofgem introduced in the 2002 price control¹. When Transco envisaged restructuring the gas balancing regime in 2002, they raised a Review Group, 513, which was very effective at developing the code to introduce new balancing arrangements, the outcome of which stated that no "radical" reform was currently warranted².

We would like to refer to, and indicate our strong support for, the Gas Forum's letter to the Energy Minister questioning the legal aspects of licence restructuring.

Now that Ofgem has revised its view on universal firm NTS charges, as it has recognised it will not work under the DN Sale scenario, it seems appropriate that this level of work continue in the same arena where it started, as to do so otherwise would be inefficient and would not be in line with best practise or good governance guidelines.

There have been three years of work on developing Exit reform culminating in Transco raising NWC modification 527, on "The introduction of Within Day Exit Scheduling charges". This modification envisaged introducing a profiling charge which reflected the price of offtake flexibility throughout the day, which is similar to what is being currently proposed by Transco under its Exit Reform Group. However, Transco later withdrew its modification, since it recognised that it was no longer needed as it could manage its NTS offtake profiles through the provision of better shipper information, rather than through more radical and costly reform of Exit arrangements.

Therefore, it is apparent that the industry has been duplicating work and effort to re-visit something that has already been discussed previously. This cannot be considered a proper and efficient process, as it results in extra and unnecessary costs to the industry. We are disappointed that Ofgem has chosen to agree with Transco's process.

Regarding policy formation, much of this is done through the many DISG meetings, yet this group had no formal powers to dictate policy, make decisions or steer the project. Some important areas of policy, such as the setting up of the Joint Office to look after the governance arrangements were introduced and formalised in one

¹ NWC workstream topic 4112 "Development of Universal firm NTS Exit Firm exit charges NWC workstream topic 5029 "development of Exit scheduling charges."

² Transco's final conclusions 513 Energy Balancing Review Report, August 2002

particular meeting³ where only a handful of industry participants were present. Members have also not been given sufficient time to review documentation.

At the same time, policy setting and standards seem to have shifted throughout the process and we draw Ofgem's attention to the way it has negotiated with Transco several key issues such as Business Separation. It appears to us that Ofgem was insistent, as well as most of the industry, in requiring legal and targeted separation to ensure Transco did not unduly discriminate between its RDNs and IDNs and chose this as their preferred route in their July 2004 Offtake document, subject to certain conditions being met⁴.

EDF Energy is concerned that Ofgem has now revised its view and conceded that legal separation is no longer efficient as structural separation will suffice to ensure Transco operates efficiently and prudently in a non-discriminatory manner. It is unclear why legal separation is not now needed, other than that it would compromise the overall net benefits of the DN Sale since it would involve Transco incurring costs to restructure its debt. Whilst we can see there may be merit in Ofgem's new conclusions, since there are other ways of guaranteeing non-discrimination on Transco's behalf through strict licence conditions, we cannot see why Ofgem does not apply the same rationale to resolve the potential discrimination it has identified between NTS DCs and DN offtakes. It should therefore introduce licence obligations and incentives for Transco not to unduly discriminate rather than introducing radical reform.

The level of Exit reform being proposed will introduce an extra level of unnecessary complexity and cost which could be overcome by strict legal requirements on behalf of Transco not to unduly discriminate between their RDNs, IDNs and NTS Shippers. We would therefore welcome Ofgem's views on how this option can or cannot be addressed through effective licensing and incentives.

Indeed, it has been established that introducing a new diurnal flexibility mechanism, as Transco is proposing, is totally discriminatory against NTS DCs for two reasons. Firstly, NTS DCs do not have the flexibility within their pipelines to manage a 1/24th flow rate as DNs can. Transco, during their 513 "Energy Balancing Review Group", stated that 60% of Linepack was held within the DNs and therefore they would have a competitive advantage compared with NTS DCs in attaining and managing a 1/24th flow rate across a day. Secondly, and most importantly, large offtakes such as gas-fired power stations or large industrial users on DNs will not be subject to the same flexibility charging regime being proposed as part of the Sale. We are concerned that this may send out the wrong signals for more embedded gas-fired generation capacity to be built on DNs rather than on the NTS.

We believe this type of process does not sit well with the Authority's duty to consider and act under best regulatory practice and we would welcome Ofgem's view on how they can justify both sides of this discrimination argument.

³ DISG number 16

⁴ Ofgem's Final Impact Assessment, 255/04a

Exit and Offtake Arrangements

EDF Energy continues to believe that reform of NTS Exit arrangements, to the extent that Ofgem and Transco are suggesting and promoting, are not warranted under a sale scenario and thus should not be a gateway or linked issue. Ofgem has not convinced the industry that reform is necessary⁵ and this area appears to create much of the greatest cost impact from the sale (even though Ofgem has not recognised this in their document). We have calculated that this would be the biggest impact to our business systems and procedures, as the risks of fragmenting the current exit arrangements are extensive, not just for the efficient operation of the gas industry but also for the electricity industry, where gas generation now accounts for c.40% of total installed capacity.

Also, the final IA does not include a fully quantitative cost assessment of the level of National Transmission System (NTS) exit capacity reform Ofgem is proposing as part of the sale. We believe this will show significant extra costs, because of the level of disruption to current industry systems and processes for gas-fired generation and industrial users directly connected to the NTS, which was not captured in the original Offtake Arrangement, due to the lack of detailed business rules available at the time⁶. It would be worthwhile for Ofgem to cost the relevant benefits of the extra diurnal flexibility product against the use of strict licence conditions on Transco not to discriminate between their Retained DNs (RDNs) and Independent DNs (IDNs), as we believe the net benefits could be significantly lower than those stated.

We believe that there is little scope for Transco as owner of the NTS and RDNs to discriminate between the NTS, DNs and other NTS DCs such as shippers and IGTs and that if there is discrimination then it will not be undue. The potential to unduly discriminate lies between Transco and RDNs and IDNs and therefore Ofgem should be structuring arrangements and the regime so that these parties, who are in the same categorisation of Gas Transporters, do not discriminate. Ofgem has recognised this distinction by recommending that DNs and Shippers remain distinct when applying for NTS exit capacity.

It is our understanding through various discussions with the Gas Forum and potential DN buyers that their main concern lies with Transco favouring their RDNs over IDNs. EDF Energy therefore does not believe that NTS Shippers and large industrial sites should be included in wide-ranging diurnal flexibility exit reform which Ofgem is proposing, as doing so will effectively lead to undue discrimination between NTS DCs and DNs.

We also believe that the diurnal flexibility product being proposed to resolve the potential issue of discrimination, as mentioned above, will hinder the efficient operation of the electricity industry and cause prices for both gas and electricity to increase at a time when energy prices have already increased dramatically in the UK. This is because Ofgem would be introducing a new level of complexity which will make it harder for gas-fired electricity producers to effectively value their extra production and bid effectively in the Balancing Mechanism. Electricity producers

⁵ Gas Forum letters Successful implementation of the Sale of National Grid Transco's Distribution Networks September, 2004

⁶ Ofgem Regulatory Impact Assessment - Offtake Arrangements, June 2004

profile their plant on the basis of spark spreads. It will be hard to predict three years ahead what type of flexibility is needed within day .

This new regime will also need complex trading and risk management systems to manage the risk associated with not buying any flexibility, especially for small or new shippers. We believe that Ofgem should undertake a separate IA based purely on the flexibility regime Transco is proposing, since we believe this could significantly negatively impact Ofgem's final benefits analysis.

Finally, EDF Energy would like to know if these arrangements will also apply to Entry given that the level of flow rate flexibility at Exit is directly related and dependent on how gas offshore is profiled onto the NTS. We believe that, by not adopting this approach, it could be seen as unduly discriminatory to Shippers and DNs at the NTS offtake point and we would therefore welcome Ofgem's views on this issue.

Industry complexity and barriers to entry

EDF Energy believes that the new industry structure Ofgem is proposing will create unnecessary complexity and act as a significant barrier to entry for new participants. Therefore, whilst we can see competition in the DN arena materialising, we also foresee a decrease in the level of new market entrants which will stifle competition in the wholesale markets for years to come. We draw Ofgem's attention to the lack of liquidity in the energy markets at present, which has resulted in higher and more volatile prices, which is blamed largely on the lack of players in the market place since traders such as Enron and Dynegy left the market. Ofgem has a statutory duty to promote efficient and competitive energy markets and should consider this negative repercussion when deciding whether or not to provide formal consent to the sale. In this respect we agree with Ofgem's reference to the detrimental effect on small gas shipper / supplier firms and note that the level of risk created by complex arrangements may be one reason why competition is less than fully effective in the gas markets today. It may also explain why some market participants are considering either consolidating their position or exiting the market.

Xoserve governance

EDF Energy remains concerned that Ofgem has chosen not to include as part of its final proposals an independent member on the board of the Agency. We believe that as things currently stand NGT will have five out of the nine votes in the majority of situations and a tenth independent member would balance out the voting rights. This tenth member could be in the form of the Gas NWC modifications panel as one vote. We believe this is needed to safeguard the best interests of Xoserve and Gas Shippers, as it is customers who ultimately pay for this service.

Customer and industry safety net

We would welcome Ofgem's view on whether or not Transco should honour the benefits stated by meeting some of the costs through a customer and shipper safety net should the benefits not materialise. Also, EDF Energy would like to further understand how Ofgem intends to guarantee that these benefits will be passed through to customers through price control reductions in Transco's allowed revenues.

Metering Aspects

EDF Energy is concerned about the very limited emphasis that has been given in the time plan/regulatory impact assessment with regard to metering arrangements (and some associated costs). There seems to have been an assumption that there would be little or no systems impact and that the metering contracts would be a simple 'lift and shift' of existing arrangements. The issues are complex and will take a good deal of time to resolve. We would like to elaborate a little below :

Following a meeting held on the 14th December, chaired by Mark Jordan of Transco Metering (Ofgem were not present), it has become apparent that there are a number of outstanding metering issues which need to be discussed and resolved before 'Hive Down' can commence on 1/5/05. If these are not resolved there may be impacts regarding meter works processes for consumers and suppliers. Below are some of the concerns that EDF Energy has following that meeting.

- No contract discussions have yet been held between suppliers and the Network Owners. There seems to be an assumption that the existing contracts will be "lifted and shifted" with each DN owner signing a contract with each supplier. This assumption cannot be made until negotiations have started between parties. The contracts which need to be discussed include the suite of RGMA contracts, the MSA, PEMS (this was uncertainty over whether suppliers have to re-sign this contract with each network owner), system user agreement and the "Siteworks" arrangements (which are not part of metering contracts but still need to be discussed in the right forum, and haven't been to date).
- New Market participant id's are required to be incorporated within the RGMA baseline. This change has not yet been seen by the industry and so Suppliers are unable to start amending systems to include them. If Suppliers do not incorporate these in time for 1/5/05, many files regarding asset work will be rejected. When files are coming out of the Transco gateway it is uncertain how the different market participant ids will affect it? Furthermore, it is uncertain whether suppliers systems' will accept a file from Transco Metering where the marker id is different from what they are expecting. This needs more careful consideration.
- Contract references will need to be changed in suppliers' internal systems. Suppliers do not have sight of these yet and so are unable to start system changes.
- For the installation of an asset the process shows two "ONJOB"s flowing to Suppliers (different market participant id's). Some Supplier systems may make a rejection when they receive the second "ONJOB". Therefore the solution needs to be that only one is sent, or Suppliers will need time to amend their systems (with costs) accordingly. Transco Metering said an "ONUPD" could be sent instead of the second ONJOB. However this cannot be done because an "ONUPD" is for an update to asset information, which is already on supplier's systems.
- The CoS process will be changing. If a supplier tries to appoint Transco Metering for an asset which is an IDN meter, the appointment will be rejected. The supplier will then have to raise a query by fax/e-mail. This culminates in their off-line database providing a "RNAME" or "ONUPD". With all the work going on in

the Customer Transfer Project to improve the change of supplier process, this is going one step back, as there could potentially be a delay in a MAM being appointed. Questions arise as to whether this new process could put a supplier in breach of their licence, and what are the timescales between Suppliers raising the query and the receiving of the “RNAGE”.

- A discussion needs to be had on the use of 'T' for “GAO”. Some supplier systems recognise this as Transco. However, under the sale 'T' could refer to a number of transporters.
- No thought seems to have been given to carrying out industry testing of the processes discussed in the meeting. A number of suppliers expressed a wish to test them
- The way forward proposed by Transco Metering was to hold one workshop a month (5 between now and hive down). This would be used to discuss contractual and process issues. This gives the industry only about 40 hours to resolve these and other issues which may arise. Transco Metering expects the contracts to be issued to suppliers for review by the end of January with their being fully signed 3 months later. These time scales are unduly tight. Transco Metering said that more meetings could be held. It was agreed at the meeting to have separate contracts and process meetings (mini MDIG and MCG equivalents). However it needs to be borne in mind that decisions need to be made to progress these meetings. The industry cannot be expected to make decisions in such a short time. Therefore there is a considerable risk that the proposed date of 1/5/04 will need to be pushed back into later in the year to ensure Suppliers are ready from a system and contractual view point.

There is another set of issues which need to be resolved once hive-down has taken place. Within the twelve month transition period new contracts will have to be negotiated. This took approximately two years for RGMA. Further system changes may have to be developed. For example, questions arise as to (a) whether each DN owner will have its own query mechanism (not part of RGMA baseline yet), (b) whether “Rainbow” can currently be used to check the asset details held by Transco Metering and what will happen if the asset is owned by the Network, and (c) whether each DN can have its own website to query asset data.

EDF Energy
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