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Dear Sonia

National Grid Transco - Potential sale of gas distribution network businesses Formal consultation under Section 23 and informal consultation under Section 8AA of the Gas Act 1986

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

Given the limited time available our response focuses on seeking to assist Ofgem in its establishment of coherent, consistent gas transportation licensing arrangements that help prevent fragmentation of existing market rules, charging arrangements processes and systems. We also comment on other matters that could in our view materially affect customers. A number of detailed points were made in our response to Ofgem's initial thoughts consultation on restructuring of Transco plc's Gas Transportation Licences earlier this year. Rather than restate many of these points, we would ask that you refer to back this response which is attached in Appendix B.

Key issues

Private Collective Licence Condition

In our September response we stressed our concern about the complexity of the proposed arrangements for restructuring Transco's transportation licences. In our view Ofgem's proposed

approach will result in the future new licence change process becoming unnecessarily costly and bureaucratic compared to the current arrangements. This may result in shippers being less able to effectively scrutinise proposals (a concern which has been raised by energywatch).

At the time we also expressed doubt about the legality of introducing the proposed private CLM procedure without reference to normal statutory procedures. Since then the Gas Forum has obtained an independent legal view on this matter, which concludes that it would be best to alter the definitions of activities required to be licensed under the Gas Act by means of an order in the form of a statutory instrument made by the Secretary of State under section 41C of the Gas Act. It further concludes that Transco's disposal of four regional gas networks is an industrial restructuring of the kind that Parliament would most likely have had in mind in enacting the section 41C process. This view which has been discussed with DTI officials is set out in Appendix A.

Ofgem continues to assert that it is legitimate to introduce the private CLM procedure pursuant to section 7B(7)(b) of the Gas Act 1995, but does not disclose the reasons why it believes this is the case. In keeping with openness demonstrated the rest of the consultation document we would ask Ofgem to explain in detail why it believes it has the powers to introduce the private collective licence condition.

We have also stressed our concern about the potential use of similar 'self modification' powers being applied to other licensed activities, such as generation or electricity distribution. Ofgem is correct in stating that it would not be possible to introduce private CLM procedures into other licences without licensee consent. Nevertheless, this doesn't preclude Ofgem citing precedents (a device successfully used in the past) to justify the implementation of future controversial licence changes.

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 limit the number of changes to charges in each year.

Unfortunately, we do not believe the transportation charging safeguards go far enough. Customers are worried that the emergence of different DN charging methodologies could increase costs for some consumers, lead to different treatment of similar size customers simply on the basis of network ownership and that added complexity will limit the number of suppliers willing to compete in particular segments of the market. Multi-site supply contracts could be particularly affected if shipper-suppliers have to offer and manage national contracts across a number of locations connected to different DNs with different charging arrangements.

As a major shipper-supplier we have identified that one of our key drivers of increased costs is the introduction of new and different discrete charging elements. We recognise however, that different levels of charges may be appropriate for particular DNs as this may in turn better reflect costs incurred in the provision of transportation services on a

particular network. This additional cost reflectivity may be justified and from our point of view is less significant in driving our costs.

We consider that it is important to establish licence conditions that subject all DNs to national charging methodologies managed by the Joint Office. This would be constituted in such a way as to not preclude different levels of charges within particular networks but would provide a stable framework within which each of the discrete charging elements remains consistent for billing purposes across the whole country.

On the reasonable endeavours obligation to limit the number of changes to charges, each year we are disappointed to see the latest proposals have changed from once a year (1 October) to twice a year (1 October and 1 April). Shippers and customers continue to have a strong preference for a 1 October once a year change. In our opinion it is the benefit of certainty a once a year change (aligned to annual contracting rounds) that is important. Variation from year to year is inevitable, but this is an unfortunate consequence of the volatile charging arrangements that have been established in recent years.

Nevertheless we understand Transco concerns with regard to its revenue recovery obligations. These concerns however, should not take precedence over the interests of customers. Nor should requests from potential buyers to align charging changes to the formula year (1 April start) rather than the established gas contracting year to which customers and suppliers are familiar be given much weight.

Rather than causing adding uncertainty and difficulties to shipper- suppliers and their customers through twice yearly changes, it would be better to directly address Transco's concerns about allowed revenue recovery. A mechanism needs to be found whereby transporters are 'not out of pocket' as a result of their decision to delay a price change to the start of the next gas year. In our view the reasonable endeavours obligation on transporters on changes to charges should necessarily be subordinate to the obligation not to exceed allowed revenue.

Network Code and Offtake arrangements

We welcome the changes to licences requiring transporters to establish the UNC, the new Joint Office Arrangements and to be a party to the new Agency arrangements. It is these elements of the Agency and Governance arrangements that offer the greatest protection against inefficient fragmentation of the arrangements. One aspect that is absolutely critical is the establishment of an adequately resourced Joint Office organisation managed for the benefit of users and other stakeholders as well as transporters.

E.ON UK submitted a number of discussion papers at the Development and Implementation Steering Committee during June and July 2004 on UNC Governance and the Constitution of the Joint Office. At the time we expressed a preference for the Joint Office to be completely independent of gas transporters but were persuaded by other shippers citing excessive bureaucracy of the 'Elexon model', that the best way of establish governance processes that were robust and no longer dominated by Transco lay with changes to the Modification Rules. Consequently shipping community through the Gas

Forum has put forward a number of proposals to the existing Network Code Modification Rules.

Unfortunately Transco have not responded positively to even the most straight-forward of shipper proposed rule changes within the recently established Network Code Governance Review Group. For example in response to E.ON UK's Mod 0709 proposal Improving the Accountability and Management of Network Code Meetings, incorporating the chairman's guidelines for managing meetings and such matters as submission deadlines and recording Panel determinations, Transco felt unable despite support form all other parties to recommend the proposal stating,

"....that whilst institution of more formal meeting guidelines might provide additional accountability, this should be balanced against losing the benefits of flexibility in the present arrangements which can assist in progressing Modification Proposals."

One might ask, whose proposal, whose agenda and whose flexibility? Transco also sought in the legal drafting to reinterpret the intent of the modification which required a further supplemental consultation. Fortunately Ofgem approved the proposal based on the 'correct' legal drafting, but only after shippers put a lot of time and effort into scrutinising Transco's actions.

Not surprisingly, in the light of these recent actions E.ON UK is becoming increasingly sceptical as to whether Transco will fully implement the vision for the Joint Office set out most recently in Ofgem's final impact assessment. A task that is perhaps made difficult by the fact that Transco is focusing its resources on parallel UNC governance arrangements as part of the Transco UNC Development Forum. We have also yet to see the detailed Joint Office rules from Transco and are afraid that these arrangements might seek to infringe on arrangements that should rightly continue to be covered by the Modification Rules.

Consequently we are no longer persuaded that the current proposal to establish a Joint Office run at arms length will be sufficiently independent from transporters. We believe it would be worthwhile establishing a Joint Office which was more constitutionally 'separate' from them, something approaching that of Elexon and its relationship with NGC. This would require a 'beefing up' of the changes to the proposed licence changes requiring the establishment of the Joint Office. Please note this is Elexon style 'full' independence but with less bureaucratic Modification Rules than those set out in the electricity Balancing and Settlement Code.

We welcome the moves to place all commercial rules within the UNC. In addition we support in principle the approach advocated for the offtake arrangements namely that technical matters are covered in bilateral agreements so that unaffected parties could not raise any modifications to these documents. Nevertheless it is important that shippers are able to propose changes to <u>all</u> commercial market rules from 'beach to meter' including NTS exit and offtake arrangements or indeed any other arrangements that currently come under the scope of the existing Network Code. These rights should not be diminished following designation of the UNC or short-form codes.

We also believe a consistent contractual approach to setting out technical terms for all NTS connectees , whether these are DNs, power stations or interconnectors is required. A way forward is for the form of many of these technical exit arrangements to be specified in the UNC, in a similar way that existing Network Exit Provisions are specified in the code but technical parameters are specified in Network Exit Agreements (NExAs) with NTS direct connects. Such an approach will ensure the UNC governs the type but not the exact values of technical parameters, thereby helping to ensure consistency wherever appropriate between different types of NTS connectee.

One other aspect that remains somewhat unclear to us is the status and scope of the short-form codes. 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.

Emergency services coordination

It does not appear to us that an entirely satisfactory solution has been found for continuation of the first response services to IGTs. It would seem appropriate, if only as an interim measure to the end of the current price control, to apply licence conditions to oblige relevant transporters to both “make safe” and carry out “repair and restoration”. We do not consider that it is prudent to rely on the 6 month extension to Transco’s current contracts, as any Ofgem review on the theoretical contestability of these services and any consequential licence changes is almost certainly take longer than this.

System operator managed services agreements (SOMSAs)

Contrary to the views expressed by Ofgem in the consultation we believe SOMSAs will persist for much longer than 18 months, if only to ‘unpick’ the organisational changes Transco is currently engaged in centralising DN system operations.

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. In practice we believe it is likely that SOMSAs will remain well beyond the end of the current price control and this in fact may well prove to be desirable as it may help reduce the motivation of new DN owners to seek to inefficiently fragment the arrangements. The lack of transparency and regulatory scrutiny of these documents may raise concerns as to the potential scope for discrimination

between DNs. We would therefore prefer to see the standard form SOMSA terms defined as an integral part of the offtake arrangements.

An alternative way forward may be to introduce a licence condition effectively regulating these documents beyond the start date of the next price control.

Amended Standard Condition 9 – Network Code and the Standard Special Condition A12, A14 and A15 - Joint Office the Common Systems Arrangements and Agency arrangements respectively

We are pleased that Ofgem has taken on board a number of concerns E. ON and other shippers have raised at DISG meetings and in response the previous initial thoughts licence consultation. It is particularly encouraging that Ofgem consider it necessary for transporters to a) introduce a new relevant objective to promote efficiency in the implementation and administration of the Network Code and Joint Office and Agency and b) require them to be party to the UNC and Agency arrangements.

We have yet to study these proposals in any detail yet, but would intend to focus on these elements as part of the formal licence consultations. One area which is considered under A15 (2) is the requirement to set out the scope of the agency within the UNC. We had hoped that this licence condition could be more explicit by requiring the listing of activities and detailed processes managed under the common services agreement within the UNC.

This 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-supplies 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 believe that there should effectively be no change to these obligations. We are concerned that Ofgem is seeking to reinterpret the definition of the 1 in 20 obligation in respect of the NTS, to help facilitate the introduction of the new radical changes to the exit regime. The current licence conditions provide comfort to firm NTS direct connects that Transco will continue to make available daily capacity incorporating within-day flexibility at flows up to 1/24 of the maximum daily quantity. It is important that any new licence conditions do not diminish the rights enjoyed by firm NTS direct connects through the introduction of an obligation which combines both booked MDQ (primary capacity) with MHQ (within-day flexibility).

Other matters

Please refer to E.ON UK's response to Ofgem's initial thoughts consultation on restructuring of Transco plc's Gas Transporter Licences of 29 September 2004, which is attached in Appendix B.

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

Appendix A	Restructuring of Gas Transporter Licences: A commentary on the legal aspects of Ofgem's proposals
Appendix B	Initial thoughts on restructuring of Transco plc's Gas Transporter Licenses - Consultation document 215/04 - E.ON UK's response dated 29 September 2004