

January 2000

Transco Pilot Restructuring Initiatives

Technical Training
Pipeline Maintenance Centre
Engineering Services

A Consultation Document

1 INTRODUCTION

- 1.1 BG Transco plc ("Transco") has approached the Office of Gas and Electricity Markets (Ofgem), with proposals to:
- transfer three businesses (Technical Training, the Pipeline Maintenance Centre and Engineering Services ('the three activities')) from Transco to BG Technology Ltd; and
 - procure competitively the services which the three activities currently provide to Transco on a monopoly basis.
- 1.2 Transco's proposals are set out in Annex A, which was written by Transco. Ofgem has raised a number of relevant issues.
- 1.3 BG Technology and Transco were both formerly divisions of BG plc. On 13 December 1999, BG plc implemented a restructuring, described in the Ofgem consultation document "BG plc Corporate Restructuring" published in August 1999 and approved in the Ofgem decision document "BG plc Corporate Restructuring" published in December 1999. The August document explained that the transfer of certain businesses out of Transco would be subject to further consultation, if such businesses were deemed to be "ancillary" under Section 36A of the Gas Act (1986) ('the Act'). Accordingly, this paper seeks views on the issues associated with the transfer of the three activities from Transco to BG Technology.
- 1.4 Ofgem believes that the separation of the three activities from Transco should aid regulatory clarity, by further reducing the scope of Transco, the regulated business, to its core licensed activities of gas transportation and LNG storage. This aim is consistent with current initiatives on the metering, connections and storage activities.
- 1.5 Ofgem also expects that the introduction of competition to the three activities should reduce Transco's operating expenditure, and hence provide the opportunity to lower prices for customers when its price control is reviewed. In addition, the introduction of competition into these three activities is a duty of the Director General of Gas Supply ('the Director') under the Act. However, the restructuring raises a number of important regulatory issues, which we discuss in the next section. As part of Ofgem's policy of regulatory transparency, Ofgem wishes to consult with interested parties on those issues.

2 REGULATORY ISSUES

Timescale

- 2.1 Transco has proposed a phased opening of its procurement of these services to competitive tendering. Following the transfer of ownership of these services, it is envisaged that they will be the sole provider of the relevant services to Transco under service provision agreements which will last for 12 months in the case of pipeline maintenance and technical training, and 18 months for engineering services, whereafter a phased opening to competition will begin. Transco has offered to open technical training and pipeline maintenance to full competitive tender within 36 months, and engineering services within 54 months. Transco's reasoning for an initial contract and phased introduction of competition are set out in Annex A.
- 2.2 As part of the transfer proposals, it is envisaged that the transferred businesses will be able to consider offering services to new customers outside the BG Group, in competition with other existing suppliers, to a greater extent than hitherto. Ofgem is minded to accept the timescales which Transco has proposed. However, if the transferred businesses begin competing in these markets during the proposed transitional period, before other businesses are able to compete for Transco's custom, it could be argued that the transferred businesses will enjoy an unfair competitive advantage.

Ofgem seeks views on whether the timescale in Transco's proposal is appropriate, or whether a faster opening of Transco's procurement to competition is possible or desirable, and whether BG Technology's businesses are likely to enjoy an unfair competitive advantage, given Transco's proposals.

Access to information

- 2.3 It will be important to ensure that potential bidders for the provision of these services will have access to information gathered by Transco for regulatory purposes on the same basis as the transferred businesses. If this is not achieved, the three activities could possess an advantage in bidding for contracts from Transco, and be able to frustrate the competitive tender process.

Ofgem seeks views on whether information held by the three activities would be a concern to external bidders, and the means by which this could be overcome.

Relationship with BG plc's corporate restructuring

- 2.4 In Annex 3 of its August consultation document, Ofgem outlined a process for considering the transfer of businesses out of the former BG plc into separate subsidiaries. As this is the objective of Transco's proposal for the technical services businesses, the proposed transaction falls within those covered by this process. Ofgem stated that, as part of this process, it may wish to consult separately on the transfer of certain businesses, in particular those describable as "ancillary".
- 2.5 Under the Act, certain businesses are considered "ancillary" to Transco's licensed activities. The Director has duties under the Act to:

- introduce competition into ancillary activities; and
 - to keep under review ancillary activities.
- 2.6 Ofgem considers that Technical Training, the Pipeline Maintenance Centre and Engineering Services are ancillary businesses, since the services which they provide are directly necessary to Transco's fulfilment of its obligations under the Act and BG Transco plc's public gas transporter (PGT) Licence ('the Licence').

Ofgem's approval required

- 2.7 Amended Standard Condition 25 of the Licence requires that the Licensee (currently BG plc) consult the Director if it is disposing of its right to operate any transportation asset. "Transportation asset" is defined as "any part of the Licensee's pipe-line system or any part of any facility being one -
- (a) used by the Licensee only for the diurnal storage of gas or for the storage of gas in connection with the operation of its independent systems, and
 - (b) required for the proper performance of its duty under section 9(1) of the Act,
- together with any estate or interest in land required for the utilisation of that system or of such a facility and for the purposes of paragraph (2A) shall include any independent system of the Licensee".
- 2.8 Ofgem is of the opinion that if a business is required for the proper performance of the duties under Section 9 of the Gas Act, then the assets used by that business will fall within the definition of a transportation asset. Therefore, on a reasonable interpretation of Amended Standard Condition 25, the assets employed by these services can be considered to be transportation assets.
- 2.9 This raises the issue of whether the transfer of the businesses involved in this proposal from Transco to BG Technology constitutes a disposal of the right to operate transportation assets. Since last year's corporate restructuring by BG plc, the PGT Licence is held by BG Transco plc, a subsidiary of the new ultimate holding company (BG Group plc). BG Technology has become a separate subsidiary of BG Group plc. Consequently the transfer of these activities from Transco to BG Technology involves the disposal of the right to operate transportation assets, and requires Ofgem's approval. In any case, Ofgem believes that if its view is required, Ofgem is minded to give its approval if that is necessary.

Transco's obligations under its Licence and the Act

- 2.10 The Act and the Licence place the following obligations (among others) on Transco:
- to maintain an efficient and economical pipeline system for the conveyance of gas;
 - to comply with any reasonable request for connection to the pipeline system and to convey gas by means of that system;
 - to purchase services from BG's subsidiaries on an arm's-length basis and under normal commercial terms;

- to act at all times in a manner calculated to secure sufficient management and financial resources are available for the Transco business and carry out its obligations; and
- to conduct its transportation business in the manner best calculated to ensure that neither it nor any related entity of Transco obtain any unfair commercial advantage.

2.11 Ofgem considers that the proposals set out in Annex A are unlikely to jeopardise Transco's fulfilment of its duties, particularly given Ofgem's additional powers of enforcement under the new Licence amendments and the Competition Act, 1998.

Ofgem seeks views on whether Transco's proposals may jeopardise its fulfilment of its duties under the Act or its Licence.

Competition issues

2.12 As mentioned above, the Director has a duty to secure effective competition in ancillary services where possible under the Act. These proposals from Transco appear to foster competition in potentially competitive activities. However, Ofgem is concerned that there may be some services provided by the three activities which are in areas of the market which are not fully contestable, for example the provision of pipeline maintenance to large diameter, high pressure connections, where the small size of the market might deter new entrants. This would mean that the three activities might have a *de facto* monopoly in certain areas of Transco's procurement, even after the procurement had been opened to competition. Ofgem already has powers under Transco's licence, and from March this year will possess powers under the Competition Act 1998, to prevent anti-competitive behaviour by Transco.

Ofgem seeks views on whether there are any activities which are carried on by the three activities which are not yet contestable, and whether any safeguards additional to those in Transco's licence and the Competition Act are required.

Terms of transaction

2.13 Ofgem believes that it is necessary to ensure that the terms on which the three activities are transferred out confer no unfair competitive advantage on those businesses when the services which they provide are opened to competition. This issue arises because the businesses to be transferred out will continue to be owned by the BG Group, and there is a danger that Transco would have an incentive to give preference to the BG Group's own businesses over unrelated companies.

2.14 Ofgem will need to ensure that there is no cross-subsidy of the competitive businesses by the regulated business (and hence customers of the monopoly). Ofgem considers that there are safeguards in Transco's licence which will prevent such cross-subsidy:

- Amended Standard Condition 11 of the Licence requires BG to conduct its business so that neither BG nor any of its subsidiaries or any gas shipper or supplier obtains an unfair commercial advantage; and

- Standard Condition 25 includes a provision preventing the Licensee from paying for goods, services or assets procured “otherwise than ... on an arm’s-length basis and on normal commercial terms”.

Ofgem seeks views on the likely implications of the terms of the transfer of the businesses from Transco to BG Technology, and in particular on whether current safeguards are adequate to ensure that BG’s technical services businesses have no unfair competitive advantage.

Implications for the current price control (1997-2002)

2.15 The transfer of the three activities from Transco to BG Technology might be held to have implications for the current price control. These businesses contain assets within the regulatory asset base, and their capital and operating expenditure form part of the expenditure for which allowance was made during the last price control review. However, Ofgem considers that the current price control should not be reopened. Price controls are set for a fixed term, which incentivises the regulated company to seek savings in operating or capital expenditure during the period of a price control. Such savings may be passed on to customers when the price control is reviewed. Removing any savings which Transco makes during the period of this price control could reduce the incentive on Transco to seek similar savings in the future. In any case, it is unlikely that there will be significant savings within the period of this price control (1997-2002), given the timetable for transferring the businesses outlined in Transco’s consultation document.

Implications for the next price control review (2002-7)

2.16 Transco’s proposals for transferring these businesses will have a number of implications for the next price control review. First, the transfer of these businesses might be held to fetter Ofgem’s discretion at the next price control because, if Ofgem gives its consent, it might be held that Ofgem had implicitly made a judgement that the transfer of these businesses would lead to efficient levels of expenditure by Transco. Ofgem makes no such representation, since the scope of the Director’s approval lies outside the sphere of price control. In particular, Ofgem reserves the right to consider at the time of the next review the implications of the transfer of these businesses for Transco’s regulatory asset value and future financial projections.

2.17 Transco’s price control review will involve analysing information in order to form a view about the efficiency of Transco’s costs. At present, for the activities conducted by these businesses, Ofgem requests information at each price control to assess whether or not Transco’s operating costs are consistent with an efficient business. The initial effect of Transco’s proposals may be to make the collection of such information more difficult, because the technical service businesses will have been transferred outside the regulated business. However, under the licence modifications implemented in response to BG’s corporate restructuring, Ofgem has powers to obtain information from other subsidiaries of the BG Group which it intends to use when reviewing the next price control.

2.18 The costs of these services may also be reduced by the introduction of competition. As argued above, in order to increase its profits, Transco must reduce its costs. Ofgem considers that competitive procurement of these services, once competition is fully established, will allow Transco to reduce its operating

costs, and should result in improved information becoming available to the regulator.

- 2.19 Ofgem is of the opinion that nothing to which it gives consent in approving the transfer of these businesses in any way fetters Ofgem's discretion at the next price control review.

Ofgem seeks views on the implications of these transactions for the next price control review.

3 VIEWS SOUGHT

- 3.1 It would be helpful to hear from all those with an interest any of the issues raised by Transco's proposals, including those highlighted above. Views are invited by 16th February 2000. Responses should be sent to:

Justin Coombs,
Director – Price Controls
Ofgem
Stockley House
130 Wilton Road,
London SW1V 1LQ.
E-mail: justin.coombs@ofgem.gov.uk

- 3.2 Since Ofgem wishes to conduct this consultation as openly as possible, we will place all replies to this consultation in our library, except those clearly marked "Confidential". If you have any queries concerning this document, Peter John on 020 7932 5941 (or e-mail peter.john@ofgem.gov.uk.) will be glad to help.

**BG TRANSCO PLC RESTRUCTURING INITIATIVES:
TECHNICAL TRAINING
PIPELINE MAINTENANCE CENTRE
ENGINEERING SERVICES**

ANNEX A

JANUARY 2000

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1 INTRODUCTION

1.1 STRATEGIC OVERVIEW

BG Transco plc (“Transco”) as a licensed public gas transporter is charged under the Gas Act with:

- developing and maintaining an efficient and economical pipe-line system for the conveyance of gas; and
- complying, insofar as it is economical to do so, with any reasonable request to connect to and to convey gas through, the system.

Transco is in the process of internally separating its Asset Management and Operations Management as part of a strategy to develop a consistent, competitive and contestable approach to service provision. This strategy is being pursued in response to increasing competitive pressure from the operations market and in response to challenges presented by the regulatory framework. Transco, as a public gas transporter, operates under a regulatory framework which places duties on Regulators to promote competition and incentivises managers to be efficient. In future it will become increasingly difficult to sustain real momentum on cost reductions whilst maintaining, or enhancing, service quality without finding new ways of doing business.

The proposed restructuring will enhance business performance by providing a more commercial approach which in turn should give greater clarity of the responsibilities for:

- operating the assets which support gas supplies;
- ensuring adherence to the necessary statutory and legislative conditions; and
- carrying out the ongoing work required on the supply system.

To be successful, however, Transco needs to ensure that there will be a managed transition from the current position, where it has direct control over activities which support the delivery of its PGT obligations, to one where such services are secured on a competitive basis.

1.2 APPROACH

To achieve these aims, three small scale initiatives have been identified which involve moving groups of activities out of Transco and into BG Technology and opening up the services they provide to Transco to competition. The activities involved are:

- the Technical Training Unit, which offers a range of technical training services to ensure the development of safety and technical competencies throughout Transco;
- the Pipeline Maintenance Centre, responsible for supplying a range of planned and emergency related high and medium pressure services to Transco; and
- the Engineering Services Unit, which provides a range of engineering consultancy and other services to Transco.

Each of these initiatives is described in more detail in sections 3, 4 and 5 of this document respectively.

The objectives of this pilot approach are to:

- build the requisite commercial capability within Transco;
- capture learning for later initiatives;

- secure early benefits for consumers; and
- demonstrate commitment to implementation.

1.3 PURPOSE OF THE CONSULTATION

The Office of Gas and Electricity Markets (Ofgem) has supported the intention underpinning Transco's proposals and are conducting this consultation to obtain an industry view on Transco's proposals.

2 INDUSTRY DEVELOPMENTS

2.1 MARKET OUTLOOK FOR UTILITY MONOPOLIES

The period post-privatisation has seen an increasingly commercial focus develop within the utility sector. Incentive based regulation has driven managers to continuously seek new ways of reducing operational costs. There is now increased pressure to perform on all activities which were historically considered to be core areas of the natural monopoly. Companies are looking to develop new approaches to improving efficiency by exploiting natural synergies across the broad range of their capabilities. There is, therefore, a move towards greater disaggregation of traditional vertically integrated utilities and the creation of companies with horizontal structures focused on multi-utility opportunities. These companies offer more than one utility service across the supply chain to similar customer groupings. Transco believes that the next few years will see an increase in the scope and scale of cross-utility operations as unbundling progresses.

Furthermore, Transco believes that there will be increased pressure on utilities to identify activities that are not inextricably linked with the management of network assets and therefore do not need to remain within the core monopoly business. In Transco's opinion, such non-core activities should, where possible, be made contestable and contracted-in by the business on a competitive basis. The process of unbundling must be on a managed transitional basis, to ensure that Transco can move safely and efficiently from its current dependency on the activities which support the delivery of its PGT obligations to a position where it can source its requirements on a competitive basis. Transco considers that so long as the basis of competition is fair and that level playing fields are preserved, these unbundled entities providing such non-core activities should be free to seek business opportunities in completely new markets.

These initiatives are not new. In a commercial world there is constant pressure to critically evaluate what is the most appropriate sourcing mechanism: insource, outsource, partnering or spin offs. The question is always one of value maximisation, either through the search for new efficiencies or leveraging off growth from synergies in new markets. It is clear from examples in other utility sectors that companies are driving forward in their search for value in related markets outside their core business area.

2.2 REGULATORY DEVELOPMENTS

The Government has referred to multi-utilities being "perhaps the greatest future challenge for regulators". Transco believes that the convergence of gas and electricity markets will reinforce market liberalisation and lead to far-reaching changes across the sector. The drive will be for companies to seek new ways of adding value against cyclical periodic reviews. It is therefore attractive for organisations to consider the need to preserve access to sufficient resources whilst not necessarily having to have such resources wholly attributable to the regulated business.

Regulators will therefore have to regulate more complex environments. In the water and electricity sectors, regulators are already dealing with this complexity arising from mergers and acquisitions. Transco understands that in areas where multi-utilities have emerged Ofwat have a set of accounting guidelines setting out the rules by which the relationships are governed. In addition, Transco believes that there are a number of other satisfactory separation models to take account of possible concerns the regulator might have over their ongoing ability to manage these types of relationships and ensure that consumers are protected.

These regulatory powers will be significantly enhanced next year as a result of the introduction of the Competition Act 1998. This Act provides the Regulator with wide ranging additional powers of investigation and determination, combined with the ability to fine

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TECHNICAL TRAINING, PIPELINE MAINTENANCE CENTRE AND ENGINEERING SERVICES
CONSULTATION DOCUMENT***

companies up to 10% of UK turnover in respect of infringements of the Act's prohibitions against anti-competitive agreements and abuse of dominant position. The Director General of Fair Trading and some of the sectoral regulators have issued a series of guidelines to explain how the provisions of the Act will be applied.

3 TECHNICAL TRAINING INITIATIVE

3.1 BACKGROUND

To ensure the competency of industrial employees, Transco employs a range of technical training services, many of which are provided internally.

3.2 CURRENT SCOPE OF TECHNICAL TRAINING SERVICES WITHIN TRANSCO

Transco currently employs a Learning and Development Operations Department, of which the unit responsible for technical training, the Technical Training Unit (TT), consists of 71 full time equivalents geographically dispersed throughout the UK. These staff are responsible for the provision of a range of training consultancy needs: analysis, design, delivery and evaluation services to internal customers throughout Transco. The services support the development and maintenance of operational skills and capabilities.

Rolling training plans are in place for each Local Distribution Zone. These focus on the development of safety and technical competencies within the operational workforce and the provision of regular update / refresher training. The purpose of technical training is to contribute towards increased productivity levels, reduced accidents / incidents and improved flexibility of the work force whilst facilitating compliance with statutory legislation. The services provided are listed in Table 1.

Service Lines
1. Identify Training and Development Requirements
2. Design, Produce and Maintain Training Solutions
3. Deliver Technical Training Solutions
4. Support Assessment Processes
5. Evaluate Technical Training Solutions
6. Administrative Support
7. Consultancy Support

Table 1: Service lines currently supplied to Transco by TT.

3.3 THE PROPOSAL

The objective of this proposal is to move to a position where Transco obtains these technical training services from a fully liberalised, competitive market. Transco considers that this will act as a spur for further efficiency improvements and encourage innovation.

In making this change, Transco's statutory and regulatory obligations must not be prejudiced. In this respect, it is essential to follow a managed transition, the first step of which will be the transfer of TT to BG Technology. This will guarantee that Transco will continue to have access to these technical training services during the transition period whilst enabling it to stimulate the development of a competitive market from which it can source its requirements in the future.

Transco will retain capability to specify and agree contracts for services, assess delivery, and ensure charges reflect market prices. The "informed buyer" will negotiate the terms of the

proposed agreement. In compliance with Amended Standard Condition 11 of Transco's Public Gas Transporter Licence, Transco will conduct its business in a manner best calculated to secure that BG Technology will not obtain any unfair commercial advantage.

Service Level Agreements for the provision of services are already in operation between Technical Training and Transco. These include detailed process maps, agreed measures and reporting frequencies. These will be refined to meet the commercial needs of Transco, prior to the transfer of activities. These SLAs are supported by a service management methodology.

The provision of technical training to ensure a competent and skilled work-force is a prerequisite for Transco. Transco believes this need could be met by other training providers in future.

After 12 months, Transco will start to open up these regulated monopoly activities to competition. This should deliver enhanced business performance, leading to a reduction in Transco's costs and ultimately to the benefit of UK gas consumers through lower prices.

3.4 KEY CONSIDERATIONS

A number of developments are emerging in the gas industry which will drive a market need for a commercial approach to technical training provision:

- increasing and non-sustainable age profile (as identified in the 1998 DTI study of the UK gas industry);
- development of increasingly liberated multi-utility markets, where companies require their employees to become multi-skilled and highly proficient in order to stay competitive;
- the views of the Gas Industry National Training Organisation (GINTO). Transco believes GINTO will view greater accessibility to quality training as a positive move for the industry; and
- facilitate the entry of new service providers into the operational services market or the public gas transporter market.

The proposal that Transco obtains technical training services currently provided by TT from a competitive market was not considered to represent a material change to the Transco safety case. A letter outlining the proposed revised arrangements will be sent to the HSE when the transfer takes place.

3.5 TRANSITION

A phased transition comprising three stages to Transco procuring these technical training services from a competitive market is proposed. This is intended to:

- ensure continuity in both the provision and quality of these essential services;
- provide sufficient time to ensure the physical, informational and financial separation of the activities from the regulated business;
- allow Transco to develop the requisite commercial skills and knowledge to procure these services from a competitive market place;
- allow sufficient time to establish and follow arrangements to procure these services in accordance with EU and UK legislation;
- enable Transco to learn the lessons from earlier phases and apply these in subsequent phases;
- allow sufficient time to enable BG Technology to develop these groups of activities into cohesive businesses;
- allow sufficient time for all potential suppliers to prepare to provide the full packages of work required by Transco thereby encouraging the development of a competitive market; and

- allow sufficient time for Transco to fully develop its business requirements, especially in light of the separation of its asset management and operations management activities.

The specific transitional arrangements are outlined in Figure 1.

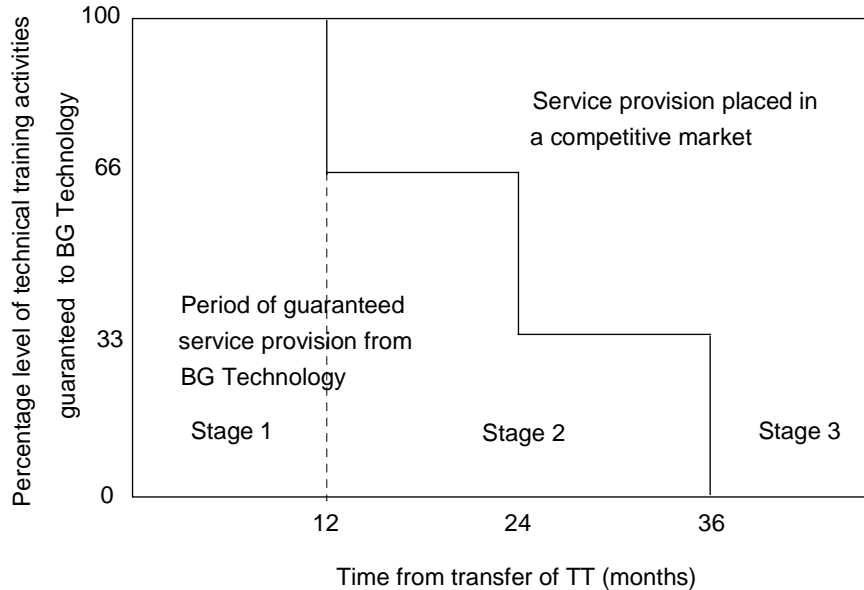


Figure 1: An outline of the transition to Transco obtaining technical training services from a competitive market.

The objective in adopting this approach is to establish a balance between the following requirements :

- ongoing support of the connections improvement programme;
- continuity of services currently provided to Transco; and
- a move to a fully competitive market.

3.5.1 Stage 1 (First 12 months of Operation)

Transco will initially establish a framework such that the technical training services currently provided by TT can be obtained from a liberalised, competitive market in a way which does not prejudice regulatory and statutory obligations.

During this stage, Transco will therefore require BG Technology to provide the technical training services that TT currently deliver. The current arrangements will be reflected in a contract which will define these services and will be in place from day one of transfer. In response Transco will provide BG Technology with an undertaking to fund these requirements on a similar basis to the current arrangements but subject to increased efficiencies.

3.5.2 Stage 2 (Duration 2 years)

Transco will establish a liberalised, competitive supply market by increasingly putting these technical training requirements out to competitive tender, in accordance with procurement rules and procedures. During the first year of this stage, Transco will competitively tender

33% of the technical training requirements it currently procures from TT. This will increase to 66% during year 2 of this stage. BG Technology and other providers will be invited to tender for components of Transco's technical training requirements, as categorised and defined by Transco.

3.5.3 Stage 3

BG Technology will be treated as any other technical training provider and will have no guaranteed work from Transco.

3.6 ROLE IN SUPPORTING INDUSTRY DEVELOPMENTS / VISION

Transco believes this proposal is strategically aligned with the vision described in Section 2 of this document. The contract management approach to technical training provision will enable Transco to satisfy its future engineering service requirements in a consistent, contestable and predictable manner.

Respondents are asked for their opinion on Transco's proposal to move to a position where it obtains the technical training services currently provided by the Technical Training Unit from a competitive market.

In particular, Ofgem welcomes views on:

- whether it is appropriate that the groups of activities associated with Technical Training be moved into BG Technology;
- whether any further safeguards should be put in place to ensure effective competition; and
- whether there are sufficient firms which could compete with Transco's Technical Training unit so that a competitive market could be established now or by the time competitive tendering is introduced.

4 PIPELINE MAINTENANCE CENTRE

4.1 BACKGROUND

In exercising Transco's responsibility under Section 9 of the Gas Act to maintain and develop an efficient and economical pipeline system for the conveyance of gas in the UK, Transco employs a range of pipeline maintenance services, some of which are currently provided internally by a group of resources collectively known as the Pipeline Maintenance Centre (PMC).

4.2 CURRENT SCOPE OF PMC SERVICES WITHIN TRANSCO

PMC was established by the then British Gas in 1973 as a rapid response capability for major high pressure pipeline and equipment damage or failure incidents. This function is referred to as the Centralised Emergency Materials and Equipment (CEME) scheme. The nature of this scheme, as an emergency standby service, carries a high support cost. Over time, these high costs have been offset by using the resources to perform complementary services such as planned pipeline maintenance, thereby allowing the supply / demand mismatch to be effectively managed. Demand for these other activities has resulted in the extension of the pipeline services provided by PMC.

The services currently provided by PMC can be grouped under the following headings:

- provision of a standby service to the National Transmission System (NTS) and Local Distribution Zones (LDZ) - the CEME scheme;
- non-emergency support work on transmission pipelines and pipelines operating at pressures below 7 bar (including large diameter polyethylene installation and connections) - this is referred to as the "Extended CEME scheme";
- project management (pipeline pigging and on-line inspection services for the NTS and LDZs, and aerial surveillance for the NTS and LDZs);
- technical consultancy; and
- management of Transco archives and records (PMC Ambergate currently holds Transco engineering and legal records).

These services are provided from three sites around the country, with a permanent work force of 63 complemented by a variable contract work force.

4.3 THE PROPOSAL

The objective of this proposal is to move to a position where Transco obtains these pipeline maintenance services from a liberalised, competitive market. Transco considers that this will act as a spur for service providers to introduce further efficiency improvements and encourage innovation.

In moving to a position where it obtains these pipeline maintenance services from a liberalised, competitive market, Transco's statutory and regulatory obligations must not be prejudiced. In this respect, it is essential to follow a phased transitional process, the first step of which will be to transfer PMC to BG Technology. This seeks to guarantee that Transco continues to have access to these pipeline maintenance services during the transition period whilst enabling it to stimulate the development of a competitive market from which it can source its requirements in the future.

Transco will develop capability to specify and agree contracts for services; assess delivery; and ensure charges reflect market prices. In compliance with Amended Standard Condition 11 of Transco's Public Gas Transporter Licence, Transco will conduct its business in a manner best calculated to secure that BG Technology will not obtain any unfair commercial advantage.

After 12 months, Transco will start to open up these regulated monopoly activities to competition. This should deliver enhanced business performance, leading to a reduction in Transco's costs, and ultimately to the benefit of UK gas consumers through lower prices.

4.4 KEY CONSIDERATIONS

Whilst PMC is currently the sole provider of the above 7 bar CEME emergency repair service for Transco's high pressure pipelines, this service constitutes only a small proportion of the activities currently undertaken by PMC.

The above 7 bar CEME emergency scheme requires the availability of 30 skilled engineers to provide a 24 hour call-out service. However, without the availability of other complementary work these engineers would be significantly under utilised. Therefore, as mentioned in section 3.2, Transco has sought to offset these high support costs by smoothing the peaks and troughs in workload through the employment of PMC resources to provide additional services.

The proposal that Transco obtains pipeline maintenance services currently provided by PMC from a competitive market was not considered to represent a material change to the Transco safety case. The HSE have however been advised of Transco's intentions and a letter outlining the proposed revised arrangements was sent to the HSE on 13th January 1999.

4.5 TRANSITION

A phased transition comprising three stages to Transco procuring these pipeline maintenance services from a competitive market is proposed. This is intended to:

- ensure continuity in both the provision and quality of these essential services;
- provide sufficient time to ensure the physical, informational and financial separation of the activities from the regulated business;
- allow Transco to develop the requisite commercial skills and knowledge to procure these services from a competitive market place;
- allow sufficient time to establish and follow arrangements to procure these services in accordance with EU and UK legislation;
- enable Transco to learn the lessons from earlier phases and apply these in subsequent phases;
- allow sufficient time to enable BG Technology to develop these groups of activities into cohesive businesses;
- allow sufficient time for all potential suppliers to prepare to provide the full packages of work required by Transco, thereby encouraging the development of a competitive market; and
- allow sufficient time for Transco to fully develop its business requirements, especially in light of the separation of its asset management and operations management activities.

The specific transitional arrangements are outlined in Figure 2.

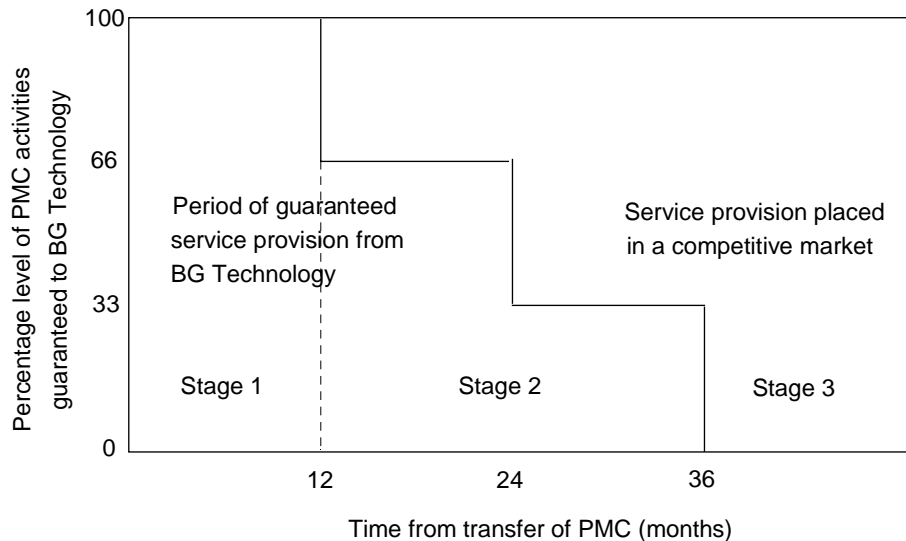


Figure 2: Transition to Transco obtaining pipeline maintenance services from a competitive market.

4.5.1 Stage 1 (First 12 months of operation)

Transco will initially establish a framework such that these pipeline maintenance service requirements can be obtained from a liberalised, competitive market in a way which does not prejudice regulatory and statutory obligations.

During this stage Transco will therefore require BG Technology to provide the pipeline maintenance services that PMC currently deliver. The current arrangements will be reflected in a contract which will define these services and will be in place from day one of the transfer. In response, Transco will provide BG Technology with an undertaking to fund these requirements on a similar basis to the current arrangements but subject to increased efficiencies.

4.5.2 Stage 2 (2 Years duration)

For all work other than the above 7 bar CEME emergency service, Transco will establish a liberalised, competitive supply market by increasingly putting work out to competitive tender, in accordance with procurement rules and procedures. During the first year of this stage, Transco will competitively tender 33% of these pipeline maintenance service requirements. This will increase to 66% during year 2 of this stage. BG Technology and other providers will be invited to tender for components of Transco's pipeline maintenance requirements, as categorised and defined by Transco.

Transco will require BG Technology to guarantee to provide the above 7 bar CEME emergency service, as defined by Transco through contractual agreement.

4.5.3 Stage 3

For all work other than the above 7 bar CEME emergency service, Transco will tender, in accordance with procurement rules and procedures, for the pipeline maintenance services currently provided by PMC within the context of a fully liberalised market.

For the above 7 bar CEME emergency scheme, BG Technology will continue to provide this service to Transco for a further 18 months. If, despite the efforts of Transco to stimulate a competitive market, one fails to develop for the provision of the above 7 bar CEME

emergency service, Transco could continue to procure this service from BG Technology. This will ensure Transco retains access to its required pipeline maintenance services, which are essential for the safety and reliability of the gas supply system.

4.6 ROLE IN SUPPORTING INDUSTRY DEVELOPMENTS / VISION

Transco believes this proposal is strategically aligned with the vision described in Section 2 of this document. The contract management approach to pipeline maintenance service provision will enable Transco to satisfy its future pipeline maintenance requirements in a consistent, contestable manner.

Respondents are asked for their opinion on Transco's proposal to move to a position where it obtains the pipeline maintenance services currently provided by the Pipeline Maintenance Centre from a competitive market.

In particular, Ofgem welcomes views on:

- whether it is appropriate that the groups of activities associated with Pipeline Maintenance Centre be moved into BG Technology;
- whether any further safeguards should be put in place to ensure effective competition; and
- whether there are sufficient firms which could compete with Transco's Pipeline Maintenance Centre so that a competitive market could be established now or by the time competitive tendering is introduced.

5 ENGINEERING SERVICES INITIATIVE

5.1 BACKGROUND

In exercising Transco's responsibility under Section 9 of the Gas Act to maintain and develop an efficient and economical pipeline system for the conveyance of gas in the UK, Transco employs a range of engineering services.

5.2 CURRENT SCOPE OF ENGINEERING SERVICES WITHIN TRANSCO

Transco established the Licence To Operate Directorate in 1997. The Directorate includes an Engineering Services Unit (ESU) formed from the amalgamation of the centre engineering policy section and the four lead area engineering units. There are two distinct elements to the role:

- the development of engineering strategy and policy to guide the delivery of Transco's statutory and regulatory obligations; and
- the provision of an engineering service to support the implementation process.

These activities are currently provided from a number of sites around the country, with a work force of 272 complemented by a number of external service providers who supply specialist know how and resources to enable Transco to manage its variable requirements for engineering services.

5.3 PROPOSAL

Transco has assessed its current portfolio of specialist engineering activities and is looking to establish contestability and competition in those services which are available in the external market. Transco considers that this will act as a spur for further efficiency improvements and encourage innovation. This constitutes the work currently undertaken by some 196 employees located across the country, referred to as the Engineering Services Unit (ESU). ESU currently provide Transco with the services outlined in Table 2.

Service Categories
Engineering Strategy, Policy, Standards and Procedures Consultancy
Audit and Compliance
Risk & Reliability Studies
Independent Design Approval Authority
Independent Incident Investigation
Competency Assessment & Training
Technical Service

Table 2 : Major service categories currently provided to Transco by ESU.

The remaining staff would be retained within Transco as they are considered to have a key role in supporting the core monopoly business as set out in more detail below.

In moving to a position where it obtains these engineering services from a liberalised, competitive market, Transco recognises the need to ensure that statutory and regulatory obligations are not prejudiced. In this respect, Transco considers that it is essential to follow a phased transitional process, the first step of which will be to transfer ESU to BG Technology. This seeks to guarantee that Transco will continue to have access to these

engineering services during the transition period whilst enabling it to stimulate the development of a competitive market from which it can source its requirements in future.

An Engineering Policy team of experienced engineers and a small support staff is being established within Transco to act as the 'Informed Buyers' of engineering services from ESU and any other service provider in the market.

The role of the team will be to:

- fulfill the informed buyer role for Transco giving advice and support to Transco on the acquisition of all specialist engineering services;
- maintain a comprehensive knowledge of all statutory and regulatory obligations and provide advice and guidance on their impact on Transco's engineering operations and influence future changes in the regulatory framework;
- ensure Transco has appropriate engineering policies, procedures and processes in place to meet its business needs;
- advise on the impact to Transco's engineering operations of the policies, procedures and processes proposed by other functions in Transco; and
- develop and maintain an engineering strategy which supports and contributes to the evolution of future commercial and regulatory controls and frameworks.

The proposal that Transco obtains engineering services currently provided by ESU from a competitive market was considered to represent a material change to the Transco safety case. In line with the requirements of the Gas Safety Management Regulations a revision to the safety case was prepared and submitted to the HSE at the end of December 1998.

The HSE formally accepted the revisions to the Transco safety case on 27th April 1999.

After 18 months, Transco will start to open up these regulated monopoly activities to competition. This should deliver enhanced business performance, leading to a reduction in Transco's costs, and ultimately to the benefit of UK gas consumers through lower prices.

5.4 TRANSITION

A phased transition comprising three stages to Transco procuring these engineering services from a competitive market is proposed. This is intended to:

- ensure continuity in both the provision and quality of these essential services;
- provide sufficient time to ensure the physical, informational and financial separation of the activities from the regulated business;
- allow Transco to develop the requisite commercial skills and knowledge to procure these services from a competitive market place;
- allow sufficient time to establish and follow arrangements to procure these services in accordance with EU and UK legislation;
- enable Transco to learn the lessons from earlier phases and apply these in subsequent phases;
- allow sufficient time to enable BG Technology to develop these groups of activities into cohesive businesses;
- allow sufficient time for all potential suppliers to prepare to provide the full packages of work required by Transco thereby encouraging the development of a competitive market; and
- allow sufficient time for Transco to fully develop its business requirements, especially in light of the separation of its asset management and operations management activities.

The specific transitional arrangements are outlined in Figure 3.

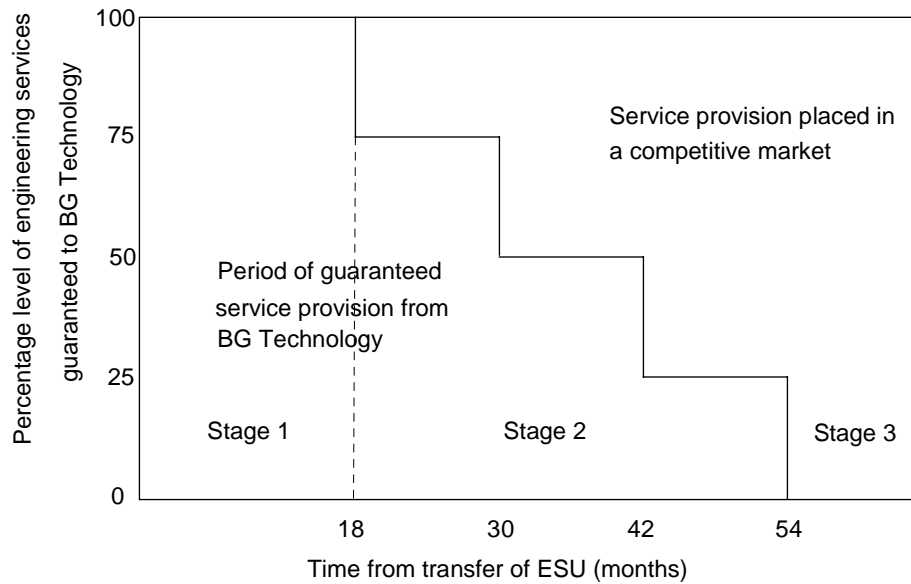


Figure 3: Transition to Transco obtaining engineering services from a competitive market.

5.4.1 Stage 1 (First 18 months of Operation)

Transco will initially establish a framework such that its engineering service requirements can be obtained from a liberalised, competitive market in a way which does not prejudice regulatory and statutory obligations.

During this stage, Transco will therefore require BG Technology to provide the engineering services that ESU currently deliver. The current arrangements will be reflected in a contract which will define these services and will be in place from day one of the transfer. In response Transco will provide BG Technology with an undertaking to fund these requirements on a similar basis to the current arrangements but subject to increased efficiencies.

5.4.2 Stage 2 (Duration 3 years)

Transco will establish a liberalised, competitive supply market by increasingly putting these engineering services requirements out to competitive tender, in accordance with procurement rules and procedures. During the first year of this stage Transco will competitively tender 25% of these engineering service requirements. This will increase to 50% during year 2 of this stage and 75% in year 3. BG Technology and other providers will be invited to tender for components of Transco's engineering service requirements, as categorised and defined by Transco.

5.4.3 Stage 3

BG Technology will be treated as any other engineering service provider and will have no guaranteed work from Transco.

5.4.4 Timescales

Transco recognises that the timescales associated with the introduction of competition into the provision of engineering services differ from those of the other initiatives. The rationale for this is outlined in Appendix 1.

5.5 ROLE IN SUPPORTING INDUSTRY DEVELOPMENTS / VISION

Transco believes this proposal is strategically aligned with the vision described in Section 2 of this document. The contract management approach to engineering service provision will enable Transco to satisfy its future engineering service requirements in a consistent, contestable and predictable manner.

Respondents are asked for their opinion on Transco's proposal to move to a position where it obtains the engineering services currently provided by the Engineering Services Unit from a competitive market.

In particular, Ofgem welcomes views on:

- whether it is appropriate that the groups of activities associated with the Engineering Services Unit be moved into BG Technology;
- whether any further safeguards should be put in place to ensure effective competition; and
- whether there are sufficient firms which could compete with Transco's Engineering Services Unit so that a competitive market could be established now or by the time competitive tendering is introduced.

6 RATIONALE

In establishing a competitive arena for the provision of the services associated with each of the three initiatives, Transco believes that stakeholders will realise the following benefits:-

STAKEHOLDER	BENEFIT
Customers and Consumers	<ul style="list-style-type: none"> ▪ Opens up new opportunities for efficiency and effectiveness gains through improved management focus and innovation. These will be reflected through transportation prices in subsequent formula periods.
Ofgem and Competition	<ul style="list-style-type: none"> ▪ Aligned to Ofgem’s objectives of promoting competition wherever possible, leading to enhanced consumer value and appropriate regulation of the residual monopoly. ▪ Makes expertise available to new market entrants, Independent Public Gas Transporters, self lay organisations and others at comparable commercial rates, facilitating increased competitiveness and lower prices for UK industry.
HSE	<ul style="list-style-type: none"> ▪ Provides greater transparency of Transco’s requirements and performance. ▪ Facilitates wider access to standards and capability and supports the development / improvement of safety standards in the gas and utility industries.
Transco	<ul style="list-style-type: none"> ▪ Opens up new opportunities for efficiency savings and effectiveness gains; enhances performance management; helps maintain the availability of a critical mass of skills; and will facilitate further restructuring options. ▪ Offers Transco the opportunity to purchase its requirements on an “as needed” basis at market driven competitive rates.
Shareholders	<ul style="list-style-type: none"> ▪ Enables “Gas Chain” synergies to be realised and facilitates growth strategies in related markets, both domestic & international.
Employees	<ul style="list-style-type: none"> ▪ Offers the potential for growth opportunities within the UK and international markets, thus offering significant longer term opportunities and employability for staff.

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The Government/DTI	<ul style="list-style-type: none"> ▪ Supports the development of the UK energy market and will benefit the competitiveness of the UK energy industry through the development of multi-utility markets. ▪ Exploitation of “Gas Chain” synergies in international markets will enhance the worldwide reputation of the UK energy industry, potentially leading to increased levels of exports.
Competitors to TT, PMC and ESU	<ul style="list-style-type: none"> ▪ Increased market opportunity in the UK (over a managed, phased period) for the services described. <ul style="list-style-type: none"> ▪ Increases the range of services a competitive market must provide, enabling organisations to extend their scope of work and potentially move up the “value chain”.
Service providers	<ul style="list-style-type: none"> ▪ Facilitates the development of “one stop shop” service provision.

Ofgem invites views on the advantages and disadvantages of Transco’s proposal for stakeholders.

7 MARKET OVERVIEWS

In developing these proposals, Transco has reviewed the market for the provision of the services associated with each of the three initiatives. The findings are summarised below.

7.1 MARKET OVERVIEW FOR TECHNICAL TRAINING

The technical training market within the UK has been estimated at £590 million. However, this significantly underestimates the total as it does not include training activities performed internally by organisations (Transco, for example, currently spends approximately £5 million on technical training activities undertaken by TT). The market can be segmented into eight main sectors, but is driven by the need for companies to satisfy their statutory obligations in respect of Health, Safety and Environmental legislation.

Training providers operating within the external market are starting to become more customer focused and differentiate their products, a trend that is set to continue. This has been reflected by a more flexible approach to training with the introduction of mobile units, training at customers premises and evening / weekend courses. There is also a move to provide multi-utility training, although this only covers the more general, less specialist courses.

The technical training market in the gas industry can be divided according to the pressure tiers of the gas supply system and, therefore, the specialist knowledge and experience required. The training market focused at the lower pressure bands is supported by a wide range of providers including technical colleges, specialist gas training companies and national training organisations. The perceived future success of this market has recently increased with the introduction of legislation and the Accredited Certification Scheme (ACS), for both domestic and industrial gas markets. This results in companies operating within these markets needing to have their competency assessed every five years. This has led to the development of specialist companies concentrating on the provision of refresher courses and assessment.

The number of companies offering training within the higher pressure, more specialist activities is considerably less. This is somewhat reflected by the smaller customer base, but also by the customers preferring to retain these skills in-house, whilst outsourcing their more generic training needs. The decision to outsource has been made through the need to introduce efficiency measures within the prevailing environment of significant change and increasing competition within the UK utility industry. The amount spent on training and apprenticeship schemes has reduced over recent years. This has led to a number of concerns within the industry regarding the long term availability of a workforce with the requisite skills.

Transco therefore believes that the move towards multi-utility operations and the establishment of the Gas Industry National Training Organisation (GINTO) will drive an increasing demand for high quality training within the UK gas industry.

7.2 MARKET OVERVIEW FOR PIPELINE MAINTENANCE SERVICES

PMC operates within the pipeline services market which ranges from low pressure connections and pipe inspections, re-routing, defect assessment, repair and rehabilitation on live or dead pipe work for metal and plastic pipes to high pressure emergency repair services for equipment damage or failure incidents. Transco is currently the only company in the UK to provide a national emergency service for pipelines operating at pressures above 7 bar. However, emergency work at this level only represents a minimal workload, and to ensure the utilisation of their resources is maximised, PMC operate in other areas of the pipeline services market.

The size of this pipeline services market is difficult to quantify due to the wide range of activities undertaken and the lack of available data. However, in the UK, Transco is the main customer for these services and spends in excess of £500 million per annum (of which the total cost to Transco of the activities undertaken by PMC is approximately £15 million per annum). In addition to Transco, these services are required by other pipeline operators, such as power stations, oil and gas terminals and other public gas transporters within the UK and internationally. Whilst there is limited data on international markets, gas is increasingly becoming the fuel of choice around the world, and many companies are actively developing the infrastructures to support the growing market.

With the exception of the above 7 bar gas pipeline emergency response service within the UK, the extent of competition within other pipeline services that PMC offer increases as the pressure tier decreases. At the lower pressure end of the market for example, Transco believes that there are a number of general contractors and civil engineering organisations that have broadened their capabilities. Some of these are already providing these services to Transco e.g. *Murphy Pipelines, Amec Utilities, McNicholas Construction and Kennedy Utility Services*¹. There are also a number of smaller companies that operate in niche pipeline services markets such as *Under Pressure Engineering*¹. The growth in the provision of these services within the lower pressure tier is expected to continue with differentiation expected through the introduction of multi-utility services. It is expected that there may be increasing expansion into the market for planned high pressure pipeline services, where a smaller competitive market already exists.

Within the higher pressure emergency service market, Transco believes that a number of market entry barriers exist, including initial investment requirements, emergency infrastructure, a shortage of relevant experience, and the volume of work in the market. Transco believes, however, that there is potential for increased competition from international companies, such as *IPSCO, Furmanite and T D Williamson*¹, who are providing comparable services.

Transco believes that placing PMC outside of the regulated arena would expose the unit to commercial pressures and stimulate the development of competition within the high pressure pipeline service market. In addition, placing PMC in a competitive market position enables other companies to gain access to world class skills and knowledge currently held within Transco.

7.3 MARKET OVERVIEW FOR ENGINEERING SERVICES

The engineering services currently provided to Transco by ESU would generally be defined in the external market as engineering consultancy and technical support. The market in the UK, based on fees rendered by UK consulting engineers, was worth approximately £3.9 billion per annum in 1998. However, this significantly underestimates the total as it does not include work performed by internal organisations for their parent companies. The market can be segmented into eight main sectors, of which the most relevant to the gas sector, in terms of skills and knowledge, are water and sewerage, environment, power and energy, and waste. Together, these sectors represented just over one third of the total market during 1998.

The movement towards established engineering companies seeking to market their core engineering skills outside the main business is evidenced by a number of examples where this has already successfully taken place. Hyder and ICI / Zeneca have both separated the resources necessary to offer technical support and consultancy services from the remainder of the business. The consultancy and technical support companies which have been created continue to provide services to the parent group, but have also expanded the range of services offered and their geographical and market presence.

¹ These organisations are merely indicative and their inclusion in this section in no way reflects any discriminatory relationship over and above any other potential supplier.

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The total value of the consultancy and technical support market within the gas supply industry is small. In terms of value this sub-sector of activity represents only 0.5% of the engineering consultancy and technical support market. Market leaders do exist, but competition is strong. The market share of the top three firms within the power and energy sector has been declining in recent years.

The demand for engineering consultancy and technical support services within the gas supply industry has increased in recent years. This has been driven by two primary factors, namely the need for cost effective investment and innovation. There is no doubt that the rapid pace of change in the gas supply industry has necessitated significant innovation. Downward pressure on costs has been exerted through effective regulation and the operation of markets.

Transco currently spend approximately £23 million on engineering service provision from ESU. Transco's proposal to move ESU outside the regulated arena, and competitively procure these services from the market, could well stimulate further market development in terms of the packages of services offered by technical support and consultancy companies. In the main, the packaging of services would be customer driven and it is desirable to ensure all utility markets are subject to full competition.

8 QUESTIONS AND ANSWERS

Transco has attempted to identify areas of possible concern with respect to its proposals. These are outlined below together with Transco's response.

8.1 HOW WILL TRANSCO ENSURE CONSUMERS' INTERESTS ARE PROTECTED?

Transco recognises the importance of the need to protect all aspects of consumers' interests. These interests expand beyond economic arguments of price reduction into areas of safety, security of supply and standards of service. As a minimum, the Gas Act 1995 and Transco's PGT Licence place certain obligations on the Managing Director, Transco, to ensure that the company takes its responsibilities seriously. In addition to this, Transco has taken note of the Government's commitment to consumers as signaled by the recent DTI review of utility regulation. In this respect, Transco has analysed its proposals from a number of different stakeholder perspectives and taken into account all relevant factors from its external environment. Moving forward, Transco has recognised the need to seek the agreement of Ofgem and the HSE, to ensure that all relevant legislative and licensing issues are taken into account.

Transco recognises that consumers will want assurance that these changes will not lead to any disadvantage in terms of the prices and performance that they could expect were these activities to remain as part of Transco. The framework described in Sections 3, 4, and 5 of this document, in particular during Stage 1 of each of the transitions, is intended to achieve this. But Transco believes that the interests of consumers will be promoted if these activities are transferred out of the regulated business, and that introduction of competition in their provision will lead to greater benefits than can be expected from within the regulated arena. However, Transco believes that both consumers and its own interests are best served by the introduction of competition at the earliest possible opportunity. In moving from the current position where Transco directly employs the resources required for the delivery of these services to one where these services are procured from a competitive market place, Transco recognises the need for a managed transition period. Transco believes that its proposal for a phased transition, where the market is opened up in several tranches, provides the optimum balance between consumer protection and the economic benefits of competition.

Finally, Transco, is aware of the need to demonstrate adequate separation between businesses to ensure that competition becomes properly established. Therefore, during the first six months of transition, Transco will put in place a separation and compliance framework building on the principles identified and agreed with Ofgem during previous separation initiatives. Ofgem has in the past found Transco's proposed arrangements to be satisfactory.

8.2 HOW WILL TRANSCO ENSURE THAT BG TECHNOLOGY DOES NOT OBTAIN ANY UNFAIR COMMERCIAL ADVANTAGE BY VIRTUE OF ITS RELATIONSHIP WITH TRANSCO?

Transco recognises the importance of complying with its duties under Amended Standard Condition 11 of the PGT Licence and competition and procurement laws, so as to avoid giving an unfair commercial advantage to any other entity. As such, Transco takes all reasonable steps to ensure that its employees are both aware of and comply with all relevant legislation.

To ensure compliance with the PGT licence, Transco has established a Compliance Code of Conduct for all employees and is rolling out a programme of training to all relevant employees. This approach is built upon the principles which have been agreed with Ofgem for previous separation initiatives e.g. the separation of BG Storage. On transfer, and where appropriate these principles will be applied to Transco's relationship with BG Technology to ensure it obtains no unfair commercial advantage.

Transco has issued a set of internal guidelines for employees on the 1998 Competition Act and Transco is in the process of rolling out a series of briefings on these for managers. The purpose of these measures is to ensure that employees understand the need to comply with the appropriate legislation and make them accountable for their compliance. Under the Competition Act (1998), Ofgem has concurrent powers with the Director General of Fair Trading to enforce the provisions of the Act including carrying out investigations into (i) anti-competitive agreements and practices and (ii) the abuse of a dominant position.

In terms of the way in which Transco buys goods and services, Transco has a procurement policy which is designed to ensure that it complies with both the letter and the spirit of the law and does not discriminate against any potential service providers.

Transco invests significant management time and resource to ensure that it complies with all relevant legislation.

8.3 HOW WILL TRANSCO ENSURE A COMPETITIVE SUPPLY CHAIN BECOMES ESTABLISHED?

Transco's expenditure on bought-in goods and services, directly and indirectly, is of the order of 50% of its turnover. In procuring these goods and services, Transco complies with all relevant EU and UK legislation.

The effective procurement of goods and services and ongoing management of this expenditure is an essential component of sustaining and generating new sources of value. A key issue is the need to strike a balance between maintaining flexibility to extract the benefits of a competitive market place and the potential to create value by establishing successful relationships with suppliers. This is achieved by:

- focusing on key business needs;
- establishing the right business relationships; and
- ensuring a continuing competitive market place;

whilst controlling costs and optimising the quality and effectiveness of the goods and services purchased. It is, therefore, in Transco's best interest that a competitive supply chain develops and, as a consequence, Transco will package service requirements to facilitate this.

All Transco employees, when undertaking any purchasing activity, are bound by a Statement of Business Principles. Adherence to these principles is checked and monitored. In addition, Transco invests in the development of its professional procurement and logistics capability through the training of its staff to standards recognised by the Chartered Institute of Purchasing and Supply.

In outsourcing its activities, Transco has recognised the need to develop an experienced 'informed buyer' capability to specify and agree contracts for services; assess delivery; and ensure charges reflect market prices. The "informed buyer" will negotiate the terms of the proposed agreement, and will be supported by representatives of the relevant business functions within Transco who will either specify or agree the organisation's technical requirements.

APPENDIX 1:

RATIONALE FOR THE TRANSITION TIMETABLE FOR THE UNBUNDLING OF THE ENGINEERING SERVICES UNIT

1 SUMMARY

Transco proposes the unbundling of the Engineering Services Unit as a forerunner of subsequent restructuring to introduce a range of competitive services to support the management of Transco's transportation assets.

The timescale proposed for the introduction of competition into the provision of engineering services differs from that proposed for the other initiatives. This Appendix describes the rationale for the different timescale.

2 CURRENT SCOPE OF THE ENGINEERING SERVICES UNIT ROLE

The Engineering Services Unit (ESU) currently provides Transco with engineering expertise and knowledge that makes an important contribution to the commercial performance of Transco and to the development and delivery of services to shippers and consumers. The expertise and knowledge is also very important to Transco's performance in a number of key safety related areas. The major services categories currently provided by ESU are described in Section 5.3 of the document.

The significance of these services has necessitated a revision to Transco's Safety Case because obtaining these services from a competitive market was considered to represent a material change. This was not the case for the other two initiatives.

3 BENEFITS FROM UNBUNDLING ENGINEERING SERVICES

The potential benefits to stakeholders from unbundling are described in Section 6 of the document.

4 RISKS FROM UNBUNDLING ENGINEERING SERVICES

There are risks associated with pursuing the competitive process too quickly.

- a) It is essential that Transco is able to ensure the availability of the requisite engineering expertise. Resources in ESU cannot be sustained if Transco workload is lost and new work has not been attracted.
- b) A loss of the engineering resource available to Transco will also present the following risks to the development of competition in gas transportation and other services:
 - unbundling proceeds without adequate technical governance leading to exposure to operational risk;
 - problems with current Transco unbundling inhibits or prevents subsequent unbundling;and
 - systems, process and standards to support competition and transportation or other services are not available.

The following factors could influence the ability to maintain a sufficient capability during the transition period and thus the success of the unbundling process:

- the profile of work for Transco during the period of transition to fully competitive tendering;
- ESU success rate in winning work from Transco when competitive tendering takes place;
- the profile of income from third parties for work external to Transco;
- the cost of restructuring to address any imbalance between workload and available resources (downsizing); and
- availability of engineering expertise.

For these reasons, Transco believes that it is imperative to have a 54 month transition to a fully competitive market for the provision of these engineering services and would argue that this is consistent with experiences from other engineering sectors where typical outsourcing contracts are usually in the order of 3-5 years.

5 TRANSCO'S APPROACH TO MANAGING RISK ASSOCIATED WITH UNBUNDLING

In order to address the risks associated with unbundling, Transco will need to carry out the following actions:

- establish a contract and management framework between Transco and BG Technology to manage the provision of services and provide continuity of work during the transition period in order to ensure the availability of engineering resources needed by Transco to fully discharge its statutory and regulatory obligations; and
- use the period of guaranteed work to:
 - research the status of the market and identify companies capable of supporting Transco;
 - develop procurement processes and capability;
 - put in place effective arrangements for recruitment and development of engineers with the necessary competencies; and
 - maintain the critical mass of ESU by developing the synergies with BG Technology to offer a range of engineering and technology services for third parties in the UK and internationally.