National Grid Transco

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Kyran Hanks
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26th September 2003

Dear Kyran,

National Grid Transco – Potential sale of network distribution businesses

National Grid Transco ("NGT") favours making the changes required to the industry structure to facilitate the sale of one or more of our networks.

Ofgem has indicated that it does not seek to promote particular industry structures and we consider that we should have the right, subject to appropriate safeguards, to retain or sell assets as we choose. Any decision to sell one or more of our networks will depend on whether we believe such sales would create value for our shareholders. However, to the extent that network sales do create value for our shareholders, we believe they will also deliver considerable benefits to consumers.

Consumer Benefits

At present, NGT improve operating efficiency through the application of our economies of scale to capture management efficiency improvements and to introduce technological innovation; Ofgem then periodically captures these improvements for consumers by resetting the price control. Single company ownership of gas distribution can be expected to maximise economies of scale but cannot exploit the economies of scope which might be achieved by other owners - for example those with overlapping utility service areas.

It is impossible to say whether exploiting economies of scale or scope will lead to the most efficient operating structure for gas distribution activities but a sales process will allow competing owners to analyse the problem and express a view. If potential buyers offer premia to our hold values it is because they expect to accrue savings over and above those which we believe can be achieved; these additional savings will be captured for consumers in future price reviews. In the longer term creating a dynamic market for such assets, through appropriate industry changes, will ensure that the assets are always free to move to those companies offering the most efficient operating model.

Ofgem has made an initial valuation of the benefits that can be achieved through comparative competition which is within the range of £150 million - £330 million. These numbers are consistent with the approach adopted by Ofgem to value the loss of comparators in the electricity distribution sector (Ofgem's May 2002 Policy Statement : "Mergers in the electricity distribution sector"). Using this approach, Ofgem has made real one-off reductions of £32 million to the revenue of each merged electricity distribution company; Ofgem clearly believes that the value of comparators is real and significant.

Arguably, Ofgem's estimate of the financial benefits of comparative competition is conservative:

- it is based on an assumption that, even in the absence of comparators, Ofgem is able to re-set operating costs at the start of each price control period to the level that would have been achieved under comparative competition;

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- it is based on an assumption that benefits are only available for 15 years; and
- it appears to ignore the possibility that multi-utility synergies available to potential buyers who already own an overlapping distribution network may exceed those available simply through comparative competition within an individual sector.

We believe that the range of benefits is likely to exceed that calculated by Ofgem and, at the top end, could plausibly be argued to exceed £500 million.

These higher levels of benefit would be consistent with merger rulings in the water. As Ofgem notes in its Policy Statement: “Detailed analysis carried out in the water sector and considered by the Monopolies and Mergers Commission indicated that the loss of comparator was potentially orders of magnitude higher.” In the proposed takeover of South West Water, Ofwat produced numbers which indicated that the value of the loss of just one comparator was between £200 million and £770 million at 1994/95 prices.

Comparative competition will also have positive non-financial impacts for consumers for example by facilitating benchmarking of standards of service and service reliability.

Consumer Costs
It will be necessary for the industry to incur some costs in order to capture these benefits for consumers. With the exception of NGT’s own costs, these costs are likely to be borne by consumers.

We would limit the costs directly attributable to our proposals to those changes that have to be made in order to facilitate the sale of one or more networks. These are :

- the costs of changes required to suppliers’/shippers’ systems, and
- resource costs for the development of licence and network code amendments.

We have constructed our proposals – set out in the consultation document itself and in our presentations at the industry workshop – with a view to reducing these costs and making implementation quicker to expedite the capture of benefits for shareholders and consumers.

Three features of our proposals are specifically aimed at minimising these costs:

- a uniform network code for Transco and the distribution networks based closely on Transco’s existing Network Code to set out national transportation rules;
- an Agency to allow retention of existing Transco and shipper processes and systems for supply point administration, transportation billing and energy balancing billing; and
- retention of a national daily gas balance.

If these features are adopted, the systems changes required to facilitate network sales are minimal and should be limited to those necessary to allow a shipper to receive transportation invoices in respect of service provided on more than one distribution network.

The proposals would still require substantial development effort and legal input to draft and review revised licences and network codes, but any costs must be *de minimis* when set against the potential benefits.

Impact on Existing Programmes
The direct costs of implementing network sales discussed above should be distinguished from adjustments required to existing reform programmes being pursued by Ofgem. In the consultation document, Ofgem draw attention to two particular areas of work:

- the exit/interruption regime and
- supply point administration.

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These programmes stand on their own merits but we acknowledge their development needs to take account of potential network sales. We note, however, Ofgem's view that they should proceed in some form regardless of whether there are network sales.

On exit and interruption, we look forward to continuing our work with the industry to define a solution which addresses perceived shortcomings. On supply point administration, we do not believe that our uniform network code/Agency proposals fetter the outcome of discussions in existing governance groups (e.g. GIGG and SPAA). In fact we would argue that creating a separate Agency would be a positive first step in the development of potential solutions currently being discussed.

The "gateway" concept introduced in the consultation is useful; it emphasises the point that industry participants should focus on what <u>must</u> be achieved in these areas prior to Ofgem consenting to network sales.

Timetable and Process
We believe that the timetable set out in the consultation document - envisaging separate ownership of distribution networks by the end of September 2004 - is tough but achievable, particularly if, as an industry, we focus on ways of minimising the impact to maximise benefits for consumers.

On the process for moving forward, we believe that a small number of workstreams will be required to develop proposals in detail. Obvious topic areas for detailed work are:

- exit and interruptions;
- balancing;
- supply point administration;
- licences;
- network codes; and
- systems changes.

Some of these topic areas could be combined into larger workstreams and some can be addressed through existing industry workstreams. Almost certainly, most of the legal and systems work will need to follow on policy discussions in other topic areas. We support Ofgem's suggestion that some form of steering group is established to monitor developments and direct the effort.

Conclusions and Summary
In summary, we believe our proposals will give rise to significant benefits to consumers. These can be accessed with minimal systems changes and at relatively modest cost to shippers.

The appendix sets out our position on the detailed points raised for consultation.

We look forward to working with industry participants on this important project.

Yours sincerely,

Chris Train
Director

Appendix

This section sets out NGT's position in respect of the detailed issues raised in the consultation document.

Regulatory architecture
This section raises two issues, both of which require a policy decision.

1. **The degree of separation required between Transco's transmission and distribution activities.**
   Ofgem is concerned to address the potential for undue discrimination and undue preference in the treatment of DNs by transmission ("NTS").

   We expect that in the first instance this would be addressed by a licence condition to require the NTS to refrain from undue preference or undue discrimination in the treatment of distribution networks.

   This would be implemented through an Offtake Agreement (between the NTS and the DNs) by providing a standard set of transparent rules that apply at the NTS/DN interface covering:
   - network planning;
   - diurnal storage;
   - operational flows;
   - interruption; and
   - gas balancing.

   We anticipate that the Offtake Agreement will be a public document and Ofgem will have a role in its governance.

   From a monitoring perspective, the treatment of DNs will be manifest through a number of transparent indicators including:
   - regional levels of interruption;
   - capacity availability;
   - maintenance schedules; and
   - diurnal storage prices.

   We would expect that any DN that considered it was receiving unduly discriminatory treatment would immediately complain to the NTS and/or to Ofgem. In summary, an appropriate licence condition together with a transparent Offtake Agreement should address any concerns regarding the potential for undue discrimination.

   Ofgem raise the question of whether or not it is necessary for Transco's existing integrated Gas Transporters licence covering NTS and DNs to be split into two separate licences or whether it is acceptable to retain a single licence with separate transmission and distribution obligations.

   Given the analysis above, we do not consider that separate licences are required. We are not opposed to separate licences however, provided that this will not result in a requirement to legally separate each licensee.

2. **Whether transportation rules should remain uniform across all networks or whether each network should be allowed (or perhaps encouraged) to diversify.**
   As Ofgem note, diverse transportation rules would have implications for competition in supply, as shippers would be required to deal with a variety of transportation arrangements across the country. The counter argument is that it might encourage greater efficiency and innovation by network operators resulting in greater choice and quality to consumers through services appropriate to particular locations.

We believe that the right answer could differ from issue to issue – for example SPA rules might remain uniform while charging methodologies could vary. Our proposals do not require resolution of these questions at this time. We propose that a uniform network code ("UNC") should be created which preserves the status quo of having a uniform set of standard transportation rules across all DNs connected to the NTS system. This proposal minimises change in the short term but leaves open the option for diversified transportation arrangements to develop if Ofgem, in consultation with the industry, decide that it would be appropriate.

Our proposals achieve short-term certainty and stability while retaining flexibility for longer-term divergence.

Application to Network Exit Agreements ("NExAs")
The Offtake Agreement will establish rules between transmission and distribution. In time it could be extended to new NTS connections, if this was thought appropriate, but it could not automatically be applied to existing NExAs; these are legacy agreements, and we do not have the power to unilaterally require current signatories to migrate to new arrangements.

Importantly, there is no requirement to change existing NExAs in order to facilitate network sales or within the same timetable.

Impact and options for exit and interruptions regime
Our proposals do not require changes to the existing exit capacity and interruptions regime and it is possible to simply reflect the existing arrangements in the Offtake Agreement.

Reform in this area is however, highly likely in any event. We have been in discussions with the industry and Ofgem for several months in accordance with our licence obligation to do so. These discussions will continue through the existing workstream regardless of our proposals to sell one or more of the DNs.

We have put forward for discussion with the industry, proposals for future development of this area based on :

- Firm only transportation on the NTS, supported by deals with power stations, interconnectors and other direct connects for demand management;
- Firm, as well as an expanded range of interruptible transportation arrangements in the DNs, all supported by administered charges;
- Development of operator to operator agreements to enable DNs to provide interruption services to NTS and/or ability for DN shippers/consumers to provide demand management services direct to NTS System Operator;
- Ability for DNs to manage the quantity of interruption rights that it may choose to release; and
- Development of DN demand management arrangements on a non-administered basis.

We do not believe that material changes of this nature can be implemented within the timescale of the disposal process, however, significant progress can be made, including definition of the solution.

We therefore propose that the arrangements to facilitate disposal (for example the Offtake Agreement) should be consistent with the existing exit regime and capable of revision at a later stage, in line with the exit and interruption arrangements developed by the industry.

Impact and options for gas balancing
We believe that the arrangements facilitating disposal should comprise of the following key features:

1. The National Balancing Point should be retained as the point across which shipper imbalances are assessed; avoiding any requirement for shippers to maintain balancing accounts with each individual transporter.

2. Residual balancing involving use of the on the day commodity market and other balancing tools, should continue to be conducted for the system as a whole (transmission and each network) by Transco in its capacity as transmission operator. This will avoid multiple gas transporters buying and selling gas to balance their networks

3. Each network should continue to retain a physical balancing role for their networks, varying flow rates from the NTS and using their diurnal storage facilities to achieve a physical balance. This role would not involve the purchase and sale of gas by networks for balancing purposes (see 2 above)

4. To varying degrees, the networks currently take diurnal storage from transmission in the form of a within day flow profile at the transmission / network interface. These operator-to-operator arrangements should continue and be addressed through the terms of the Offtake Agreement. The provision of diurnal storage should be a chargeable service, although for the purposes of consistency with the individual DN price controls, we propose that charges are initially set at zero.

Supply Point Administration
Our proposals do not require supply point administration arrangements to change. The only related change required by sale of one or more DNs is the requirement to facilitate the delivery of separate invoices by sold DNs to shippers.

We have proposed the establishment of an Agency, as a separate legal entity under the joint ownership of all DNs and NGT, as the owner of the NTS and its retained DNs. It is anticipated that each network will be funded through its price control for the provision of Agency services pertinent to its pipeline network.

The detailed specification of services provided by networks, through the Agency, to shippers will be covered by the proposed UNC. Changes to such service specification will need to follow the governance process established as part of this work.

There will be an arms length commercial contract between the Agency and the network owners that will set out how the Agency allows network owners to meet their UNC obligations. This will detail the commercial arrangements including Agency charging, incentive framework, contract duration, withdrawal terms and change management. The Agency incentive framework will include output based performance measures based on network code and GT licence obligations (including relevant standards of service and Network Code Liabilities).

Importantly, our proposal is the minimum change solution; we expect further evolution in this area recognising existing industry efforts to reassign roles and responsibilities and to develop incentives to invest in the delivery of new services

Shrinkage
Shrinkage requirements vary from DN to DN and therefore a different target shrinkage factor is appropriate for each. The costs of shrinkage will be contained within the separate price controls for each DN.

We therefore expect that DNs will take responsibility for managing their own shrinkage and would participate in the Network Code process for the setting of their individual shrinkage factors.

Gas quality
Again, our proposals have no impact on gas quality issues since they do not change the quality of inputs to the system.

Each DN will have basic statutory protection and obligations through the requirements of the Gas Safety (Management) Regulations 1996 ("GSMR"). The Offtake Agreement will contain provisions relating to gas quality that reflect GSMR requirements.

Safety cases
To facilitate our proposals, a separate safety case (for both gas conveyance and emergency co-ordination) will be required for each DN. Transco's safety case will require revision and each of the new and amended safety cases will require acceptance by the Health and Safety Executive.

We have agreed a programme of work with the HSE in order to deliver these changes within the proposed timetable.

Emergency services
The national emergency telephone reporting number will continue to be managed by Transco, in accordance with GSMR, and will be provided to each network under contract.

The first response workforce, which first attends emergency calls, will be included in the sale.

Network planning
The existing aggregate obligations of planning, development and security standards at each tier of the system will remain unchanged. The co-ordination required to achieve this is expected to be set out in licence conditions and in the Offtake Agreement.

Transmission and distribution price controls
Given the objective of minimising short -term price divergence it is possible that some adjustments will be required to the RVs set out in Ofgem's final proposals paper on LDZ price control separation[1]. We are currently conducting analysis in this area and will be discussing the outcome with Ofgem.

Mains Replacement Expenditure Cap
The loss of an aggregated cap for mains replacement expenditure together with regional variance in mains replacement workload may mean that DNs could, under current arrangements, have insufficient funding to undertake mains replacement work in accordance with HSE requirements

Our view is that where this occurs individual caps should be relaxed by Ofgem to ensure funding aligned with the requirements of the mains replacement programme.

Distribution charging methodology
In the longer-term we recognise that divergence of charging methodologies between DNs might encourage innovative services. However, we note that this would be inconsistent with the current initiative in electricity to standardise services and charging. Nonetheless it may be justifiable in certain cases.

Should individual DNs come forward in future with proposals to amend their charging methodology, further industry consultation would be required at the time to consider possible benefits and set these against the impact on supply competition.

Pensions
We agree with Ofgem's view that the funding of pensions costs of employees past and present are part of the operating costs and should be funded through the price controls.

We favour the regulatory approach set out in the consultation document for recovery of the legacy pensions costs and believe we can demonstrate that this does not adversely affect the consumer interest and does not unduly constrain future development of the NTS price controls or market mechanisms for the allocation of exit capacity.

Metering
In recognition of competition in the metering market, we do not currently propose to offer our meter assets for sale as part of this transaction. This will remain under review.

Asset Risk management
Our proposals will provide enhanced comparators in this area through the policies and practices of each DN.

[1] Separation of Transco's distribution price control - Final proposals June 2003

Status of potential purchasers
The HSE will require assurance regarding the capability of any potential purchaser to run a gas distribution network.

Whether or not the status of any potential purchaser raises implications under competition law will not be known until buyers are identified. NGT and the potential purchaser will discuss this with Ofgem in due course.

Security of supply
We do not consider that our proposals have any impact on security of supply.