National Grid Transco – Potential sale of network distribution businesses

Consultation Document

A Response by British Gas Trading

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EXECUTIVE SUMMARY OF RESPONSE

British Gas believes that the proposal to sell one or more DNs may result in one of the most significant changes to the gas industry since privatisation and accordingly thorough investigation is required.

We consider the main issues fall into four areas:

- The Regulatory Impact Assessment
    - We believe that the assessed value of the comparators used by Ofgem is overstated and hence that the customer benefits are likely to be significantly less than is indicated by Ofgem's Initial RIA
    - The approach proposed in our OXERA study commissioned by British Gas provides a more realistic assessment of value
    - The underlying assumptions in the Ofgem RIA have not been fully justified
    - The costs have not been fully scoped or quantified
    - The best practice guidelines for RIA development should be followed, including a further consultation on the Full RIA

- Timescales
    - In our view, the timescales are optimistic
    - The proposed changes are too important to be rushed
    - The timescales need to be decided after the full scope of work is defined, not before

- Lack of Detail
    - The current proposals are mostly at a high level, this is understandable for a first consultation
    - We support Ofgem's wish for industry input to the proposals
    - In order for industry development on these proposals to commence, a greater level of detail and clarity is needed on the future shape of the industry

- Customer Impacts
    - Acceleration of Geographical Pricing, the creation of winners and losers and potential for customer confusion
    - Increased risk of data degradation leading to exacerbation of customer service issues
    - A robust net customer benefit has yet to be demonstrated

British Gas believes that unless a clear and unambiguous net benefit, to customers and the community, can be demonstrated, NGT should not be given approval to proceed.

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CHAPTER 1: INTRODUCTION

In its presentation of preliminary results, NGT signalled its intention to sell one or more distribution networks (DNs) and has recently confirmed this position. The consultation document is presented as the start of the process by which NGT would achieve Ofgem's approval for such a sale.

Ofgem states they do not seek to promote any particular industry structure over another and do not in principle oppose NGT in pursuing the sale of the DNs. NGT gives a preferred way forward in many areas, stressing a route of least pain for the industry. Ofgem has also given some initial views on their general inclinations, again, mostly along the "least pain" route.

British Gas believes that if the potential sale of a DN is not properly thought through, and all relevant details evaluated, there are likely to be damaging effects on the industry. Many of the proposals referenced in the document could lead to an industry which has all the disadvantages of fragmentation and none of the benefits that might accrue from greater separation. In particular, the proposals as promulgated would lead to an industry suited to the needs of NGT which may not reflect the needs or aspirations of the industry stakeholders and particularly the interests of customers.

The timescales suggested are very optimistic and would appear to be driven by NGT's desire to move quickly. British Gas cannot condone fundamental change being rushed through based on the aspirations of a single party, believing timescales should be drawn to fit the workload.

Our second area of concern is the Regulatory Impact Assessment (RIA). Whilst we appreciate the inclusion of an initial RIA in the document, we believe that greater analysis is required in a number of key areas, including the cost-benefit analysis, risk assessment and underlying assumptions. We understand that a RIA is developed in stages, but given the timescale for implementation of these proposals; we consider that the RIA should be significantly more developed to enable consultees to provide high quality responses to the consultation, thus adding value to the process.

In addition, it is our view that the lack of detail in the proposals will reduce the ability of consultees to respond effectively to the consultation. NGT's "least change" Agency proposals contain elements that appear contradictory and may act to constrain participants' ability to influence the operating environment. We have concerns in respect of the Agency proposals as presented, and on the basis of our current understanding wish to record our opposition.

There is a need for analysis at a detailed level in order to determine whether the proposals offer any benefit to customers, initial analysis by our consultants indicates lower benefits than those in the consultation document. We have been undertaking extensive analysis on the proposals, this work will be progressed further and Ofgem informed accordingly; meanwhile, these comments reflect our high level concerns.

Currently, the indications are that there may be some benefits but significant costs, however, it is only if the outcome is a net benefit that the case for change can be justified. British Gas is not yet persuaded that the outcome would be positive.

STRUCTURE OF THE DOCUMENT

This response is a preliminary document which will be followed by a further paper to Ofgem once our analysis is more advanced.

In chapter 2, we examine our main concerns with the proposals as they stand. The issues will be considered under a number of headings:

- Process
- Ownership
- Governance
- Gas Balancing
- Portfolio Operations
- Other Issues

Chapter 3 considers key points to come out of the RIA
Chapter 4 reviews identified customer impacts, with particular reference to prices
Chapter 5 contains our conclusions to date

The appendices include a description of our working issues matrix (more detail is supplied under separate cover to Ofgem on a confidential basis), a thorough review of the RIA and associated issues and a copy of a report commissioned by us from OXERA to assist us in our analysis. The consultation timescales have been such that this report has been completed only very recently. Our final conclusions drawn from it will, therefore, be included in our second document.

We consider, however, that OXERA's report may be helpful to the discussions, and so have decided to make a copy available to Ofgem at this early stage. OXERA's work challenges the benefits that would be delivered by sale to such an extent that industry costs may well outweigh the benefits.

A further appendix provides more detail where issues have only been briefly referenced in chapter 2.

CHAPTER 2: REVIEW OF ISSUES RAISED BY THE PROPOSALS

In the consultation document, Ofgem has presented a number of options and in some areas has given an initial view on an appropriate way forward. NGT has also clearly indicated their preferred path. British Gas is not persuaded that the current proposals are the best way to provide for the potential sale of a DN, were NGT to achieve the HSE and Ofgem's approval to proceed.

In view of our concerns, especially those relating to timescale and the RIA, we have taken the approach of identifying all the areas and issues we believe would prevent this project from proceeding, unless a solution is reached which is satisfactory to all parties. The scale of some of these issues leads us to believe that it is not possible to achieve proper resolution in the indicated timescale.

In this chapter, we review some of the headline issues, where these are noted in brief, appendix 4 provides more explanation.

2.1 Process

In this section, we address each of four areas in turn:

- Fully inclusive process
- Gateway Concept
- Timescale
- Tensions

2.1.1 Fully Inclusive Process

The industry has considerable expertise in operating in the competitive gas and electricity markets; it is therefore appropriate that proposals for fundamental change should be developed in conjunction with participants. This development should be followed by a formal consultation, accompanied by a guideline compliant[1] full RIA, with proper time for consultation to allow all parties to contribute to the outcome. In addition, we believe that the RIA is of such significance that it merits a separate consultation (see Chapter 3, Appendix 1 and the OXERA Report in Appendix 2). The outcome of such a process should be more robust and practical to operate, than one where change is hurried through on the basis of an aspirational timescale.

British Gas has noted the contrast in this consultation process compared to other consultations conducted by Ofgem. The procedure used historically in respect of change of this magnitude has been, at a minimum, consultations on Initial Proposals and Final Proposals plus a decision document, prior to the industry embarking on fundamental change. The Cabinet Office guidelines on consultation indicate a 3-month consultation as being desirable in each case. Given the seriousness of this issue, we would expect that any variation would be towards more consultation rather than less, to allow for proper iterations prior to a decision to proceed.

These major proposals will alter the fundamental dynamics of the supply chain. Therefore we would encourage Ofgem to follow the "initial, final and decision document" type process and to allow the recommended 3 months for consultation at each stage.

2.1.2 Gateway Concept

We believe that the gateway concept could prove a valuable tool in the go/no go decision making process which should eventually result from these proposals, but we consider that a cautious approach is needed in employing a new concept as a decision making tool on such an industry critical issue. In our view there are four key points to consider on gateways:

[1] Better Policy Making: A Guide To Regulatory Impact Assessment, published January 2003, Cabinet Office

- The issues for which gateways are set
- The levels at which the hurdles are set
- The correct timescale for each gateway
- Provision for iterations

British Gas believes clear criteria for each stage should be specified and tested prior to use. In the proposed timescales, if the initial criteria were later found to be inadequate or wrong, there would be virtually no opportunity for correction, as irrevocable decisions may have been taken as a consequence of passing through the gateway.

It is our opinion that it would be helpful for an industry expert group to meet with the relevant Ofgem team. The purpose of the meeting(s) would be to review and challenge all aspects of the gateways bulleted above, and to create the opportunity to build participant lead times into the project programme if the decision to proceed is made. Finally, time would be needed for iterations through the gateway process as issues reached resolution, in order to ensure the structure as a whole remained robust.

2.1.3 Timescales

The third area of concern is that of timescale, we do not believe that robust industry change on this scale can be achieved in the timescales suggested, which are optimistic in our view. Normal project management processes indicate the following stages in development:

- Scope
- Detailed definition
- Impact assessment
- Cost Benefit Analysis
- Timescales
- Approval
- Implementation
- Review

In our view, it is not appropriate to declare an aspirational timescale for the entire project before it has been properly scoped, defined, assessed (from the perspective of all participants) and costed. If the earlier stages in the process indicate that the net effect of the proposals is harmful, then approval to implement should not be given.

British Gas believes that in the circumstances it is reasonable for the Authority to take an initial high level view on whether or not it is worth proceeding. However, this should be followed by full consultation on all major issues before a formal decision is made to start work on developing mechanisms to give effect to the changes.

2.1.4 Tensions

A number of tensions, conflicting objectives and perverse incentives are evident in the proposals, and there are elements which appear to contradict current arrangements.

Whilst it may be possible to overcome some of these issues; others may prove intractable. In either case it is important that all issues are clearly identified and the risk of temporary or lasting harm assessed. We believe these areas have not yet been properly addressed either in the main document or the RIA, with the result that responses to the consultation may be incomplete.

2.1.4 (a) Perverse Incentives

Our key concern in this area is the way in which the sharing of best practice might be impacted if DNs are in separate ownership. Currently, Transco has strong incentives to disseminate best practice across its regions, including: economies of scale; minimisation of costs; sharing of technological advantages; innovations and shared skills.

Under separate ownership, such sharing would lead to a reduction in regulatory and competitive advantage, acting as a disincentive to pool innovations and experience. This would be expected as a natural consequence of separate ownership in a competitive regime. R&D costs for IDNs will be higher (on a per customer basis) and so returns would need to be higher (relatively) to justify investment. Under shared ownership more marginal innovations may be cost effective. R&D costs are also likely to be duplicated by the individual DNs, leading to higher overall costs than would be the case under common ownership.

Moreover, we consider that when units are under common ownership, there may be an opportunity for some units to inappropriately profit from frontier benefits, whilst others, equally inappropriately, receive catch up targets. Alternatively, a frontier unit could hold back additional improvements in efficiency to avoid associated units facing catch up targets.

2.1.4 (b) Conflicting objectives

Separation can be viewed as a mechanism to enable flexibility and differentiated services, yet the pressures to keep costs down and operate economically and efficiently act to push the industry towards simplicity, commonality and economies of scale.

In order to avoid the natural consequences of this tension, a careful balance needs to be struck between the conflicting drivers, this is not easy to achieve. The real danger is that differentiated services may mean repackaging, such that services automatically included now become expensive optional extras. In the long run this may mean that customers pay more for no improvement in service.

2.1.4 (c) Contradictions with current practice

The principle example in this area is the proposed use of an Agent as a “one stop shop” for Shippers and Suppliers, which clearly contradicts current arrangements in some areas such as siteworks, new connections and query management.

2.2 Ownership

In this section, we explain our initial views on ownership and separation. The issues centre on industry structure post sale, and can be grouped according to whether the DNs are owned by NGT or not.

Where the DNs are not owned by NGT, the main concern is around the status (financial and legal) of the new owners; the potential for collusion between IDNs; the provisions which might be required to protect the IDN as part of a larger business; possible insolvency of an IDN and the ability of other DNs to exert influence, undue or otherwise, over the business and operations of the IDN. In addition, where IDNs are acquired by electricity DNOs, gas and electricity interactions as well as data confidentiality issues should be evaluated to ensure there are no adverse impacts.

Where the DNs are retained by NGT, and subject to the specific licensing arrangements put in place, we believe there might be potential for IDN’s to be disadvantaged if NGT are not prohibited from:

- discriminating between RDNs and IDNs (either on a collective or individual basis) and favouring RDNs;
- driving through or hindering change; and
- controlling the way in which the industry would operate.

To clarify, under the collective licence modifications, if NGT NTS and the RDNs all held separate licences, and each raised objections to change, we consider that it might be possible for NGT alone to constrain developments which other IDNs support.

In electricity, the difficulties encountered in separating the Distribution and Supply Businesses were sufficient to require the appointment of compliance officers, accountable at a board level, in each case. It is likely that achieving robust separation between NGT NTS and eight DNs, may be even more difficult and hence we believe similar provisions may be needed.

We believe that the proposals should also take account of the requirements of the EC Directive (2003/55/EC), Article 13 which requires the separation of distribution from other activities by 2007.

Finally, in order to support transparency and confidence, we believe it would be important for the entirety of the proposed Offtake Agreement to be placed in the industry domain.

2.2.1 Regulatory Accounting Guidelines (RAGs)

British Gas is of the opinion that, in order to protect against both intentional and unintentional discrimination, the NTS and DNs will ultimately need to be physically, financially and legally separate; such separation might even be seen as a prerequisite for sale. This accords with the solution used to separate electricity distribution from supply and gas distribution and transmission from supply. It is also the solution proposed by most commentators with respect to the monopoly elements of BT and those elements that are prospectively competitive.

Following the separation of the DNs from the NTS, both those that remain under the common ownership of Transco, and DNs which form part of another larger entity will require accounting separation and accompanying RAGs to ensure the robustness of total and allocated costs.

Our initial thoughts on the issues that will need to be covered include:

- Extent of transparency
- Attribution of shared costs
- Level of disaggregation of shared costs
- Extent of commentary and explanation of trends to support the accounts
- Approval procedure of methodologies by Ofgem
- Audit options i.e. 'true and fair'
- Materiality thresholds

Due to the inherent difficulty of the allocation of shared costs on a non-arbitrary basis, we believe that there should be incentives on Transco and other common owners to minimise shared costs. We also believe that Ofgem should provide early guidance on the level of financial ring fencing under which the DNs would need to operate. Our initial thoughts are that the provisions that are currently in place in the electricity sector could provide the level of protection required by DNs.

The RAGs will need to be both detailed and prescriptive, with provisions for market testing (on cost and value) where internal services are provided.

2.3 Governance

In this section we detail our concerns relating to governance under a number of sub headings, additional detail is provided in Appendix 4, 2.3.

2.3.1 Network Codes

After reviewing the proposals in this respect, we understand the clear drivers for a Uniform Network Code (UNC), and indeed, this appears to be a sound approach. However, we consider that the proposals are still embryonic and require a great deal more clarification and extensive industry development.

Particular areas for consideration include:

- Which body would administer the code
- Code Vires and Governance

- Interaction of the code with other documents
- The order of precedence of industry documents
- Provisions for modification;
- Inclusion of the modification rules within the main body of the code
- Synchronisation of change
- Management of file formats and their governance
- Signatories
- Potential future divergence
- Whether a licence obligation should be placed on IGTs to sign the proposed framework agreement.

2.3.2 Licensing

In the document, NGT's and Ofgem's views in respect of licensing appear divergent. Whilst we have concerns with the proposals in general, we are inclined to believe that separate licences as proposed by Ofgem would be preferable, should the proposals be progressed.

The development of two separate types of GT Licence to reflect the different groups of licensed network operators is not a trivial task, and given its importance, sufficient time must be allowed.

We have noted the work carried out by Ofgem (under the separation of the LDZ Controls) in respect of establishing a glidepath for price divergence at a customer level. British Gas would wish to be assured that the licence requirements for consultation in respect of changes to charging methodologies in the new licences would be at least as stringent as they are now. We believe this is needed because, although the levels of charging may not change immediately, a new owner of a DN might wish to amend the way in which revenue is collected (see points made under demand attribution). Such amendments might have significant impacts on pricing, quotations and transportation billing, all areas in which rapid structural change is undesirable.

The issue of licensing is strongly linked with the previous points on Ownership and Separation and British Gas is of the opinion that licence development should not be started until the evaluation process for these proposals has been completed. Our reasoning is that as well as containing the Licensee's duties and obligations, the Licences will need to support the industry structure once defined.

British Gas also believes the effects of the collective licence modifications process (in relation to the "separate licences" proposal) need to be evaluated. If proper safeguards were not in place, for example, if the NTS and RDNs all held separate licences, and were not treated as one "entity", the RDNs might be able to frustrate change. However, it is not clear to us how collective behaviour could be distinguished from parties independently reaching the same conclusions.

2.3.3 Agency Arrangements

British Gas believes NGT's current proposals in respect of Agency Arrangements may prove unacceptable to much of the industry. Whilst we appreciate that if the proposal to sell one or more DNs received approval, some form of centralised service provider would be both desirable and unavoidable, we are of the opinion that it could not be operated as an NGT business unit and yet be viewed as independent.

The reasons for our belief include:

- The ability for the Agency Users to specify the service to be provided
- Responsiveness to User requirements in respect of system and code developments
- Neutral positioning – an independent Agent would be free of operational constraints
- Transparency and accountability
- Improved cost control and targeting

We are also of the view that it should be possible to design an Agent structure in which the needs of all participants are given equal weight, providing natural checks and balances.

If such a Service Provider were to be created, it would be important to go back to first principles in designing the service to be received and the method of provision. Part of the process would be to learn from the experiences of the past in both the gas and electricity markets. There are fundamental questions which need to be addressed prior to scoping the services to be provided, more detail is provided in Appendix 4.

British Gas does not believe it is appropriate for NGT to advise of the service which will be provided by such an agent or provide the terms of the agency contract, believing this task should be carried out in consultation with the service users.

We also believe that the proposals may exacerbate the difficulties faced by the industry in providing good customer service. Most would agree that problem areas persist, which in turn cause difficulties for customers. If, as is implied by these proposals, a "black box" scenario developed, the problems would remain, but participants would have less visibility of the causes, leading to greater difficulty in resolution.

2.4 Gas Balancing

The consultation document is at a very high level, but in view of the timescales, we believe more detail is needed in the responses to provide a clear picture of where, in our view, the major difficulties lie. In this section, we highlight three areas, the remainder being addressed in Appendix 4.

2.4.1 Common Systems Interfaces

This issue applies equally to the area we describe as Portfolio Operations.

A fundamental requirement is that the systems interfaces must support all existing processes and developments thereof, and where change is contemplated, proper consultation and timescales must be factored in. NGT believes its proposals will provide a "no change" scenario for the industry, however, we are not convinced this will be the case given the scale of change. Systems divergence would have a major impact on the way the industry operates. It could lead to fragmentation, cost escalation and degradation of data quality, the cumulative effect being an increase in the problems experienced by customers.

It is already acknowledged that the utilities industry has a number of data quality issues; rapid change on this scale would lead to increasing problems, with the potential to undermine consumer confidence as a result. For this reason alone, the proposals must be approached with the greatest possible caution.

2.4.2 TO/SO Relationships

In our view, the consultation is rather ambiguous in respect of the Transmission Owner/System Operator (TO/SO) relationship(s) and activities. The document refers to both single and multiple SOs and to differing activities according to whether the system is balanced in aggregate or at a DN level. There appears to be an intent, common to both NGT and Ofgem, for a single System Operator for purposes of Energy Balancing. This does provide simplicity in retaining the current arrangements where balance is managed across the system as a whole.

Paradoxically, the other aspects of operational management of the DNs would seem to indicate a preference for separate SOs for each area of the network (NTS and each DN). We anticipate that this raises the potential for significant conflict between the operations carried out by each of the SOs and the pursuance of the incentive arrangements which will apply to each of them. The gas industry has been subject to the interaction of energy and capacity measures since the inception of Network Code and the issue has never been completely resolved. The prospect of this being further complicated by the interaction of the individual SOs' optimisation of their networks adds an unnecessary complexity to the regime.

2.4.3 Neutrality and Incentives

This is related to the TO/SO point raised above, but is not covered by the consultation. We believe that the question of whether DNs should be deemed Neutral is fundamental to much of the rest of the discussion that is required. If DNs are to be Neutral on energy, then a robust set of incentives will be needed to constrain their behaviour appropriately.

The points above raise a number of questions in respect of the SO incentives, including; whether Transco SO should be protected in some way, should the activities of DNs lead to it performing poorly against its incentives; where liabilities might rest if SO/DN conflicts lead to increased exposure for Users; how the actual neutrality processes might need to change and amendments which might be required to NGT's existing incentives to encourage the desired behaviour under the proposed regime.

2.5 Portfolio Operations

2.5.1 General

We have already touched on many of the issues in this area which might affect the way in which Suppliers operate their businesses. In our view, the main impacts would result from the Agency Arrangements, Timescales and Governance.

In addition to our concerns around the future operation of the SPA processes and their governance, the issues on Data Quality, Data Ownership and Systems, we believe there are several other areas that must be addressed, which we detail in Appendix 4, 2.5.1.

The gas industry is already in the throes of two major changes, RGMA and the Reform of the Exit Regime. In suggesting timescales, we do not consider that the proposals give proper recognition to the burden these changes are already placing on industry resources, or the inevitable interactions that must result if approval to proceed as proposed is given.

2.5.2 RGMA

The document does not consider the implications in respect of RGMA, though it is noted that NGT does not intend to sell the metering equipment currently in situ.

RGMA is a fundamental change to the operation of the gas industry, and the associated changes are relevant to any debate around potential disposal of a DN and germane to the Agency Arrangements previously discussed. We believe that RGMA is a key dependency for these proposals. The RGMA developments are proving extremely stressful for all industry players, and provide a cautionary example for future implementation of change.

2.5.3 Reform of the Exit Regime

Reform of Exit and Interruption has been escalated in the agenda of industry change by the inclusion of specific obligations in Transco's GT Licence at the last price control review. In respect of the proposals on Exit and Interruption, British Gas is disappointed that they are not a more accurate reflection of the industry discussions to date. The Industry has put considerable effort into moving the debate forward, but the proposals contained in the consultation document imply a need to restart the discussions from first principles.

We believe the most effective way to address issues around interruption would be to continue the work done to date until the form of the regime is known. If approval for DN disposal is given, provisions could then be made to support the Exit/Interruption regime as it has developed, which should be in line with customer and participant requirements. In addition, we believe that the additional layer of complexity introduced by separate DN ownership may potentiate the risks of reform.

Singly, either of these changes has the potential to cause major difficulties; together the impacts are even greater. British Gas does not believe that disposal of a DN should detract from the essential work which the industry needs to undertake in order to achieve these objectives, or be contemplated until both these reforms are complete. It is also important that Exit Reform and RGMA are implemented in such a way as to be robust to separate ownership of DNs.

2.6 Other Issues

Areas which we have not addressed in previous sections are listed below, each point is further expanded in Appendix 4, 2.6.

2.6.1 Pensions

2.6.2 Solvency, Status and Termination issues

2.6.3 LDZ Mains Replacement Programme

2.6.4 LDZ to DN Mapping

2.6.5 Transportation invoicing and Reconciliation by Difference

2.6.6 Issues not otherwise identified or addressed

CHAPTER 3: THE REGULATORY IMPACT ASSESSMENT

Key Points

In this section we have summarised the key points to come out of our review of Ofgem's initial Regulatory Impact Assessment (RIA) on the sale of one or more DNs. We have included a full and comprehensive review in Appendix 1 of our response.

We support the use of RIAs to aid the decision-making process on all significant policies initiated by Ofgem.

The proposal to sell one or more DNs may result in one of the most significant changes to the current gas industry since privatisation and accordingly demands thorough investigation. We welcome Ofgem's public declaration, at the stakeholders' seminar on 10th September, that consent will not be given unless the benefits case is clearly proven.

We see the preliminary assessment carried out by Ofgem as a useful first step, but have serious misgivings concerning the proposed consultation process and the initial assessment of the costs and benefits.

We strongly urge Ofgem to follow best practice for the consultation process as outlined by Government, and endorsed by the NAO, to formally consult with stakeholders on the final RIA. We consider that shortcutting the process would be a grave misjudgement and would not be acceptable to industry stakeholders.

With regard to costs, we believe that these have been significantly underestimated and we will be providing more realistic costs to Ofgem subsequent to this response.

We have greater concerns regarding the benefits included in the assessment and believe that these have been significantly overestimated. Our concerns are heightened by the lack of detail provided on the assumptions that underpin these initial estimates. We list below those of particular concern.

- We are surprised by the absence of any supporting material on the assumption that there would be an increase in annual efficiency savings of 1.3% on controllable opex following the sale of all the DNs. We understand that this figure has been derived from analysis of historic DNO and transmission performance and believe that the recently announced changes in the regulation, and operation, of the DNs draws this comparison into question.

- We have been unable to replicate the estimate of 4.3% per annum efficiency savings achieved by the DNOs which forms a key component in the derivation of the additional savings available post the introduction of a comparator, our understanding is that this should be in the range of 3.1% - 3.8%. (See OXERA report in Appendix 2)

- We would welcome an explanation of how Ofgem has arrived at a NPV figure of £330m resulting from a 1.3% reduction in operational costs (our modelling suggests a figure close to £144m).

- We do not follow the rationale behind the assumption that 50% of the available benefits will arise from the sale of one DN. The OXERA analysis suggests that perhaps a fifth of the benefits would arise were one DN sold.

It is clear from our work so far, that much uncertainty surrounds the inputs to this RIA, and we suggest that, given the consequences of this decision on the industry, there appears to be a strong case for a far more comprehensive and transparent review.

Understanding the importance of this RIA, and the part that the correct identification of the benefits plays, we have recruited the skills and expertise of the independent economic consultants OXERA to assist in this area.

The key results from their extensive research and modelling are that the benefits case for the sale of one or more DNs is considerably less convincing, the following table summarises these results.

Table 3.1: Comparison of consumer benefit estimates (£m)

	Sale of one distribution network	**Sale of all eight distribution network businesses**
Ofgem	150	330
OXERA—no loss of scale economies	34 to 44	149 to 218
OXERA—loss of scale economies equal to 5% of OPEX	17 to 24	7 to 68

The OXERA results highlight that the benefits associated with selling DNs may be significantly less than that estimated by Ofgem. They also indicate that the benefits are sensitive to losses in scale economies, suggesting that a better understanding of these may be warranted.

CHAPTER 4: CUSTOMER IMPACTS

As previously stated, we believe that if not properly considered and managed, the proposals have the potential to affect participants' processes in ways that will adversely impact the service customers receive and their perceptions of the market. We consider that the impacts on customers might arise from both operational processes and pricing.

4.1 Operational Processes

Customers should not notice the operation of the processes which support the competitive gas market, transfers between suppliers should be simple, quick and accurate. However, where problems do arise, they usually have their roots in data quality, either the quality of data held in respect of their premises, or data specific to their transfer which is utilised by the old or new supplier.

There are a number of key questions on data, including: how it is transacted; in what systems data is held; how system interfaces are managed and how quality is maintained throughout the process.

We believe it is necessary to prepare a full list of industry contracts which will require amendment to reflect IDN/RDN separation and to evaluate the impacts on each. The costs of renegotiation of such contracts will also need to be included in the RIA. Examples include contracts in respect of Connections and Meterworks.

If a side effect of the proposals is to degrade data quality, the number of customers suffering problem transfers will increase. This problem may be exacerbated by the Agency Arrangements currently proposed, as resolution could become more difficult. Under the current regime, when problems occur, it is usually possible to identify the root cause and resolve it. A "black box" approach to the provision of services by the Agent would be expected to reduce the transparency of the process, increasing the difficulty of resolving problems as well as the frequency with which they occur.

If, as we suggest, participants specify the services required and mode of delivery, it should be possible to address many of these issues and even improve the customer experience, but not if fundamental change is rushed through without proper project management.

The points above assume a "like for like" approach. If common systems interfaces and a UNC were not maintained, customer service impacts would be proportionately greater and participant costs would rise, and so would the prices experienced by customers.

Future divergence of service offerings by the DNs, if not carefully managed would lead to differential services to customers which might not be reflected in prices paid, particularly if risks of discrimination between RDNs and IDNs are not addressed.

4.2 Pricing

British Gas considers that the single biggest disadvantage of these proposals is the effect they are likely to have on end customer prices.

Cost divergence will be felt by customers when regional variations in charges are such that they cannot be absorbed by suppliers as part of the normal costs of business. A supplier whose portfolio is fairly evenly distributed geographically, will be able to manage minor regional differences, for example, the NTS Exit variation which currently exists. However, margins are small and the scope for further smoothing is limited. Suppliers will all have a different point at which they can no longer absorb variance, but once one supplier introduces regional prices, others will be forced to follow suit to avoid collecting a loss making portfolio of customers.

In their document on separation of the LDZ Price Control, Ofgem recognised the risk posed by geographical pricing post separation, and went to considerable lengths to try and mitigate that risk. British Gas was prepared to accept that the effect of the resulting proposals, under common ownership, would delay geographical pricing, however, we believe that the disposal of a DN poses a very real danger to these mechanisms put in place by Ofgem to reduce the risk. DN sale could be expected to lead to geographical pricing much earlier than Price Control separation alone.

British Gas considers that geographical pricing, though more cost reflective at a local level than postalised charging, would be detrimental to customers in aggregate. One of the areas we believe Ofgem should review in more detail is the distributional effect of geographical pricing, but, on average it is likely to be no more cost reflective than current arrangements. However, cost reflective pricing would be disadvantageous to many customers in rural locations, which may affect a disproportionate number of the fuel poor, leading to more difficulty in paying bills and increased hardship in affected areas.

In addition to the main body of customers, it will be important to consider the effects of truly cost reflective pricing on those customers connected to the Scottish Independent Networks or supplied with LPG in Stornaway, Llanfyllin, Llanwrtyd Wells and Colden. Currently, these customers are heavily cross subsidised and it is not clear whom would bear the cost of this subsidy, or whether the customers in the Scottish and Welsh DNs would effectively pay.

More detail is given in Appendix 5 on specific impacts as well as a second order price control effect which we believe might bring variable prices as early as 2005.

CHAPTER 5: INITIAL CONCLUSIONS

As previously explained, British Gas has not yet completed its analysis of the proposals and our conclusions are based on our understanding at this point.

In general our understanding leads us to the conclusion that the potential harm resulting from these proposals to customers is likely to outweigh the benefits, an effect which may be exacerbated if the changes are hastily implemented.

The consultation document fails to address in sufficient detail a number of significant issues and how such issues might be managed under each of the scenarios. British Gas understands that this may be due to Ofgem's desire to consult the industry on the shape of future changes, a wish that we fully support. Our concern is that in order to carry through the consultation process properly and supportively, several iterations will be required on the high level structure of a new regime, before any detailed planning could commence.

NGT is a price controlled, regulated monopoly, largely protected from harsh commercial reality by its Price Controls. Whilst we understand that NGT wishes to participate in the commercial environment as permitted by its licence, it cannot be permitted to push through major change without the industry having proper time to consider, and plan for, potential impacts.

We understand the NGT approach, which is to persuade the industry to take a least change/least pain route for the immediate future. British Gas is not persuaded that this is an appropriate way forward, especially in the area of Agency Arrangements as currently proposed.

We believe that in order to minimise costs to the industry, it is essential that all key issues are resolved and planned for before participants are required to start changing their processes and systems.

Our conclusions at this stage of the consultation are, therefore:

1) We believe that the assessed value of the comparators used by Ofgem is overstated and hence that the benefits are likely to be significantly less than is indicated by the Initial RIA.
2) When all participant costs are evaluated and considered in the full RIA, it is our opinion that the net benefits would be marginal at best and are, in fact, likely to be negative.
3) If the RIA produces a negative net benefit, approval to proceed should not be given.
4) In our view, the timescales suggested are optimistic, we believe that proper time for full evaluation must be allowed for proposals of this magnitude
5) The industry as a whole has a duty of care to our customers to ensure we provide the best service we can; we believe these proposals have the potential to adversely impact our ability to do so.

We will work with Ofgem, NGT and the industry to produce a thorough evaluation of the proposals.

APPENDIX 1: THE REGULATORY IMPACT ASSESSMENT

1. Introduction

We welcome the inclusion of Ofgem's preliminary Regulatory Impact Assessment (RIA) on the possible sale of one or more DNs and acknowledge that the purpose of this RIA is to provide only a preliminary evaluation of the costs and benefits associated with a sale.

We fully endorse the employment of the RIA tool to help inform major decisions on policy options and commend Ofgem for embracing this growing trend in better regulation.

We share Ofgem's view that the principle objective when considering a sale must be to ensure the protection of customers' interests. Accordingly, we believe that it is essential that sufficient time is allowed for a full and robust assessment to be undertaken and only if the policy option can be clearly and unequivocally proven to provide a net benefit should consent be given. We believe that for such a potentially significant change to the UK gas industry, anything less will contravene best practice and be open to challenge.

We acknowledge the part the industry has to play in the production of the final RIA if it is to achieve the sufficient standard to provide the Authority, and the industry stakeholders, with the confidence for them to make an informed decision to either proceed, or not, with the proposed sale.

We understand the complexities and difficulties involved in attempting to accurately quantify the costs and benefits associated with a potential sale of one or more DNs and because of the importance of this assessment have engaged OXERA Consultants to assist. OXERA are acknowledged experts in benchmarking and comparative competition with extensive experience gained from the water and energy industries. The full report may be found in Appendix 2 and a summary of their views on the Ofgem approach, how they believe this could be improved upon and the key conclusions has been included in Section 4.

2. Process

We do not underestimate the importance of this work and are reassured by Ofgem's public announcement that consent from the Authority will not be forthcoming unless the RIA demonstrates a net benefit. Therefore, given the importance of this issue, it is essential that time is allowed for a proper assessment of the potential costs and benefits and that a rush to completion is not dictated by NGT's commercial desires.

We acknowledge Ofgem's current view that the preliminary assessment is significantly positive. However, we are concerned that if this is based on inappropriate assumptions, this conclusion could be fundamentally flawed. Based on the independent work OXERA has undertaken, it appears that our concerns are well grounded and we believe that much work is needed to firm up the numbers included in this assessment to provide the confidence needed to support such a significant decision.

We are surprised that Ofgem proposes to move from the preliminary assessment to a full assessment without an interim report as recommended by the Cabinet Office report of August 2000 "Better Policy Making: A Guide to Regulatory Impact Assessment" and endorsed in the NAO's November 2001 report "Better Regulation: Making good use of Regulatory Impact Assessments".

We are deeply concerned that Ofgem has not yet confirmed that it will consult further on the final RIA. Given the importance of the issue, we would strongly urge it to do so.

We firmly believe that industry players will have the most informed view on the external costs that this policy decision will have. We also believe that they will be well placed to contribute to the assessment of the potential benefits. In our view, not to consult further would be a serious failure in the prescribed RIA process.

We also believe that for Ofgem to fully utilise the RIA as a powerful decision-making tool, it should consider a two part RIA. The first stage should be to assess the broad issue of whether a sale of a DN would provide net benefits to customers and provide the Authority with the confidence to either grant or withhold consent. Dependent on consent being granted, a second RIA would commence to inform Ofgem as to the best policy options to be adopted.

3. General Principles

In order to support Ofgem in the development of a comprehensive RIA we offer the following observations.

We agree with the NAO assessment that three factors characterise effective RIAs and these are:

- Starting early
- Consulting effectively with those affected by the proposals
- Analysing appropriately the likely costs and benefits of the proposals.

We have concerns that if these fundamental characteristics are not fully addressed, there is a real risk, that one of the most important decisions regarding the gas industry since privatisation will be taken based on inadequate information, and could result in customers being exposed to an unacceptable levels of risk.

3.1. Starting early

We have serious concerns that the proposed timetable is being artificially accelerated by NGT's desire for an early sale of one or more DN and this may conflict with Ofgem's responsibility to produce an adequate full RIA. While the real opportunity for an early commencement of this assessment may have already been lost there should still be ample opportunity for a full and comprehensive assessment to be carried out before any irrevocable decision is reached. We strongly urge Ofgem to give this process as long as needed to ensure it is completed to the standard required.

3.2. Consulting effectively with those affected by the proposals

As we have previously stated, it is generally accepted that to produce an effective RIA, all those affected by the proposals should be consulted. The main benefit of this is provide clarification of the impact and to source accurate information on the costs and benefits. To that end we welcome the inclusion of the preliminary RIA and the opportunity to provide comments.

However, we do not consider that Ofgem will be meeting the prescribed level of consultation unless it provides the opportunity for stakeholders to respond to the conclusions in the full RIA. Stakeholders have a legitimate right to review the assumptions and application of information used, the and to pass final comment on the RIA. This review obviously needs to be undertaken prior to any decision being made by the Authority.

3.3. Analysing appropriately the likely costs and benefits of the proposals

The Cabinet Office clearly states in its guide to RIAs, that a cost and benefit analysis plays the central component in an assessment. It goes on to advise that when assessing both the costs and benefits care must be exercised to include only those that are additional to those which would have occurred if no action were taken. This is a key point and, given the recent developments in the regulation of the LDZs, believe that much analysis will needed to provide a robust RIA that only includes costs and benefits pertinent to a sale of one or more DNs. We expand upon our thoughts below.

We understand that on April 1st 2002, Transco reorganised its low-pressure network from 12 LDZs into eight regional networks. Each regional network has a separate management team and is accountable for its own performance. According to Transco, the new management and operational structure will promote further efficiency and cost reduction under the current single price control for the distribution network, although the nature of the performance regime is not public knowledge.

Ofgem confirmed that the restructuring and creation of regional networks should lead to better information on the costs of distributing gas within each regional network. The additional information in turn is expected to improve the accuracy with which the regulator can set performance targets and price caps at the next price-control review. In this manner, the additional information will benefit customers through lower LDZ charges which will be passed through via the suppliers.

Following this Ofgem, concluded that additional benefits would stem from Transco's reorganisation by the introduction of separate price controls. These additional benefits were based on the following arguments.

- The greater opportunity to use comparative regulation. The main source for the additional efficiency savings is the use of comparators in future price controls, giving explicit revenue and cost targets to the different management teams, instead of relying on an internal management scheme designed by Transco.

- Greater management focus and thus efficiency savings over and above those realised by the separation of the LDZ at management level.

Separate price controls and the transparent attribution of costs and revenues to regional network operators will provide efficient planning signals, and thus may encourage efficient investment and consumption decisions.

Therefore, in view of the benefits already stemming from Transco's reorganisation at LDZ level and those anticipated from the introduction of separate price controls, the central question raised by the proposed sale is what additional value the introduction of an independently owned DN will contribute.

Finally, it is essential when comparing costs and benefits that this is done on a consistent basis, in particular we are concerned that whilst Ofgem has attempted to quantify the set up costs associated with this policy it is unclear whether the figures quoted include the ongoing costs to the industry and regulator. Comparing costs and benefits need to reflect where these occur over different points in time. For example an NPV approach may provide a common basis for comparison. Also, uncertainty needs to reflected in the estimates.

3.3.1 Costs

With regard to costs we are currently undertaking work to assess the impact a sale of one or more DNs would have and will be providing a more detailed assessment in our second response. The main areas identified so far include:

- Operational costs, including loss of economies of scale and scope in operation of the distribution networks;
- Higher costs incurred by suppliers in dealing with separate network operators
- Additional costs incurred by suppliers in modification of customer billing systems to handle regional pricing;
- Increased costs of customer information and management;
- Distributional costs including adverse impact on certain regions and/or groups of consumers;
- Increased costs of providing an emergency service and national priorities possibly being compromised by reduced flexibility in the use of qualified and experienced labour in providing inter LDZ support.
- Impact on small firm – the sale of a DN will bring forward the move to regional pricing. Some system adjustment costs will be fixed irrespective of the size of enterprise. Therefore there will be a disproportionate adverse effect on small companies.
- Data management and quality – a degradation in quality will lead to hugely increased costs to serve, for example in query management erroneous / failed transfers, meter reading processing, invoices etc.
- Agency costs – additional processing and receiving costs. The OXERA analysis argues that the only incremental costs of setting up a separate Agency are those associated with separating these functions from NGT. These costs include a one-time-only separation cost, and an ongoing loss of scale economies. A comparison with Elexon, the equivalent of the Agency in the electricity market, suggests that these costs are below £5m. These costs are not currently included within the preliminary RIA.

3.3.2 Benefits

With regard to valuing benefits, we acknowledge that this often provides a greater challenge than assessing costs, and the benefits associated with these proposals are particularly challenging.

It is essential that the benefits and costs are rigorously assessed and that Ofgem does not automatically assume that the benefits outweigh the costs.

We understand Ofgem's belief in this policy stems from the additional benefits expected from increased operational efficiencies derived from a new owner and price control comparator benefits. It is essential in the next revision of the RIA that Ofgem clearly justify the assumptions and conclusions that they have reached.

We fear that Ofgem's simplistic approach to valuing benefits will lead to an overestimation which will result in misplaced conclusions. We believe that much work is needed in this area if the conclusions from the RIA are to be sufficiently robust to facilitate informed decision-making. We expand upon our concerns below.

Firstly, we do not believe that the currently assumed additional 1.3% annual reduction in controllable costs is sustainable. We understand that this figure has been derived from the difference of the efficiency savings historically achieved by the DNOs with those compared to transmission. Applying this to Transco's networks post restructuring and separate price controls appears flawed and we refer Ofgem to the OXERA report for guidance on this.

Secondly, we question the accuracy of Ofgem's derivation of the value that an additional 1.3% savings in controllable costs contributes. We have attempted to replicate Ofgem's £330m based the methodology we believe was employed in calculating the value of a DNO comparator. It appears that Ofgem has discounted the cumulative benefits and thus has double counted the savings. Our analysis indicates that the true value is less than half of Ofgem's at around £144m. This discrepancy suggests that, if Ofgem continues to employ this approach (which we would not recommend), there is a clear need for greater transparency of the methodology and assumptions employed.

Thirdly, we have been unable to replicate the 4.3% efficiency savings achieved by the DNOs which forms a key component in the derivation of the additional savings available post the introduction of a comparator, our understanding is that this should be in the range of 3.1% - 3.8% and refer Ofgem to the OXERA report.

Finally, we believe that the value associated with the selling of one network is smaller (around a fifth) than that assumed by Ofgem (around a half).

4. OXERA's Report

In order to improve our understanding of the benefits that may accrue from single and multiple comparators we have sponsored OXERA Consultants to estimate the consumer benefit that may result from such a sale. The report may be found in Appendix 2 and the key findings of the report are as follows.

4.1 Ofgem's Methodology

OXERA concluded that there appeared to be two potential problems with Ofgem's approach:

- the estimated increase in the rate of efficiency improvements in comparative and non-comparative industries is difficult to reconcile with evidence across sectors; and
- an inconsistency between the stated value of separate price caps, and the value that is implicitly assumed within the preliminary RIA, ie, Ofgem has stated that the separate price controls have some value, while implicitly assuming within the preliminary RIA that they have zero value.

Each of these is examined fully and OXERA conclude that Ofgem's estimate for the increase in annual efficiency savings associated with distribution network sales appears to use a methodology that does not necessarily yield a positive gap between efficiency achieved under a comparative regulatory regime, and that achieved under a non-comparative regime. In addition, there seems to be an inconsistency between the assumption within the preliminary RIA and a previous statement by Ofgem regarding the value of the separate price controls that have already been applied to NGT's distribution network businesses.

4.2 OXERA's Methodology

Following the critique of the Ofgem approach, OXERA propose an alternative approach to calculate consumer benefit which, based on their extensive and renowned expertise in this field, they believe to be more robust. This approach is based around the concept that that there are two key mechanisms whereby the sale of a distribution network provides benefits to consumers; changes in regulation and changes within firms.

- The changes in regulation includes the greater confidence in the data being provided from independent firms than it would in data being submitted from the wholly owned subsidiaries of NGT. This translates into greater confidence in estimates of the location of the efficiency frontier and the ability to set more challenging targets.

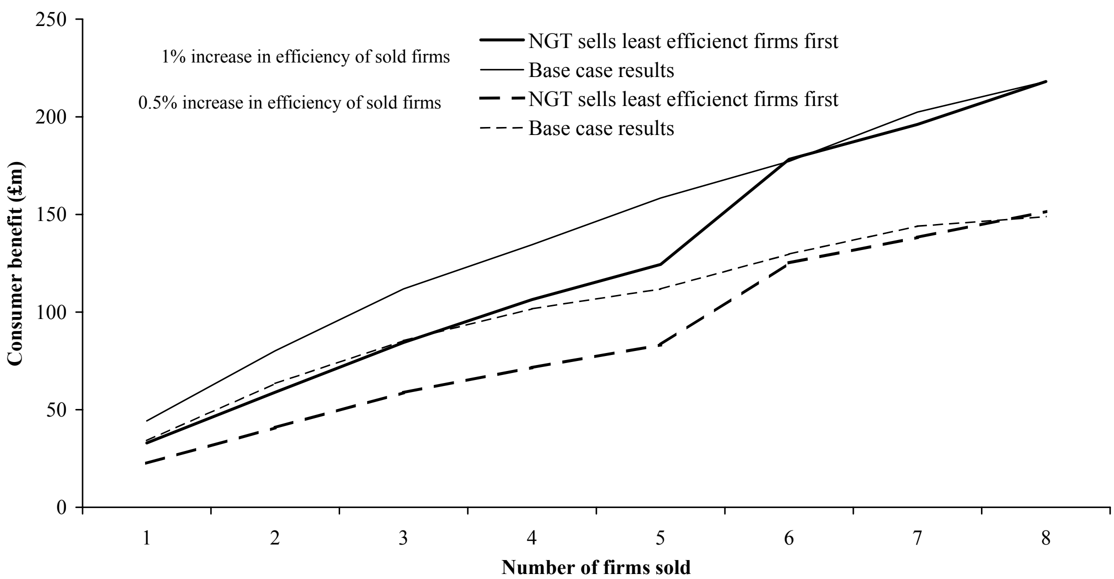
- The changes within firms includes the ability new management will have on extracting efficiency savings above those they replace.

Evidence on the size of the potential efficiency benefit associated with the sale of DNs is limited; therefore a scenario-based approach was adopted. The modelling assumes a high value for the benefits of 1% per annum, and a low value of 0.5% per annum meaning that an independent DN exhibits between 3.5% and 4% annual efficiency savings, while retained DNs exhibit 3% annual savings. The model assumes a uniform distribution of inefficiency at period reviews ranging from 0 to 30%, implying an even spread of inefficiency in firms on average. For the first review the observed inefficiency is random, for subsequent reviews it is correlated to improvements in previous reviews.

The model runs two parallel scenarios, the first where no DNs are under common ownership, the second where one or more are sold. The models output compares the difference between the two scenarios.

The following graph illustrates the consumer benefits of selling networks at different efficiency rates and includes the likely scenarios where NGT chooses to sell its least efficient networks first.

Figure 4.1: Impact of NGT choosing to sell its least efficient distribution networks first



The report goes on to assess losses in scale economies based on the experience of the electricity sector and concludes with the following results.

Table 4.1: Comparison of consumer benefit estimates (£m)

	Sale of one distribution network	Sale of all eight distribution network businesses
Ofgem	150	330
OXERA—no loss of scale economies	34 to 44	149 to 218
OXERA—loss of scale economies equal to 5% of OPEX	17 to 24	7 to 68

4.3 Conclusions

The OXERA model has produced substantially different estimates for the net consumer benefit associated with the sale of NGT's distribution networks from Ofgem's RIA. Table 4.1, which compares the Ofgem estimates with the key OXERA estimates, shows that, assuming no loss of scale economies, the OXERA estimates are between one-third and one-half smaller than the Ofgem estimate for the sale of all eight distribution network businesses. In addition, the OXERA estimate for the sale of a single distribution network is significantly less than a half of the benefits of selling all eight. With no loss of scale economies, selling one distribution network yields between around one-fifth and one-sixth of the benefit of selling eight.

When losses in scale economies are included, and Ofgem does not attempt to share the costs between producers and consumers from these, the OXERA estimates are even smaller. If all eight distribution networks are sold, the estimated benefit is between £7m to £68m, and between £17m to £24m when only one is sold. If Ofgem decided that firms should bear some of the cost of scale economy losses, the estimated benefit would lie somewhere between the two sets of results presented.

APPENDIX 2: OXERA REPORT

APPENDIX 3: ISSUES MATRIX

Whilst the issues matrix itself will be issued to Ofgem under separate cover as a confidential document, we include here a list of the broad categories and numbers of issues we have identified to date.

Process Issues	Fully inclusive process Gateway Concept Timescales Tensions
Ownership Issues (6)	Ownership Separation
RIA Issues (7)	Cost Benefit Analysis incomplete Identification and measurement of impacts Selection of DNs for sale Overall costs
Governance Issues (19)	Network Code Licences Agency Arrangements SPAA Data Catalogue/UK Link
General Operational Issues (8)	Common Systems Interfaces TO/SO Relationship Neutrality IS Ownership and Development
Daily Operations issues (49)	Balancing Requirements Nomination Requirements Capacity Holdings Revenue Recovery Interruption Safety Cases Scheduling Charges Linepack/Diurnal Storage Trading and Cashout Operations Guidelines SO Incentives
Portfolio Operations (57)	Supply Point Administration Reconciliation by Difference Shrinkage Query Management and Standards of Service Data Quality Meter Operation Demand Attribution, Forecasting and related processes Pricing Invoicing Calorific Values CSEPs

	Liabilities Theft of Gas Daily Metering, Meter Reading and Telemetry Primes and Subs/SSMPs Incident Management Emergency Testing Exercises
Other Issues (21)	Regulatory Accounts Asset Related Issues Cost Reflectivity/Cost Targeting Insolvency SoLR RGMA Cost recovery Status of Purchasers

APPENDIX 4: ADDITIONAL DETAIL ON CHAPTER 2.

In this appendix, the material is referenced according to the section numbers given in Chapter2. In each section, we have listed areas in which we believe there is reason for concern. However, we acknowledge that some of these issues relate to areas in which the consultation document contains only limited information.

(A.4) 2.3.1 Network Codes

The consultation document highlights the possible future development of separate Transmission and Distribution Codes, which implies regional divergence over time. There is a lack of provision for managing the potential impacts of such divergence which needs to be addressed.

It is also worth noting that such divergence would appear to be moving in the opposite direction to the EU generally where there might be expected to be a move to a single internal market. Centrica's experience of the European jurisdictions where there are lots of distributors with separate terms indicates the creation of high barriers to entry.

The potential for future divergence highlights the need for fundamental review of certain areas of the current arrangements, to ensure these are satisfactory before risking divergence. Examples include bulk transfers, where, if the industry wishes to put in place such arrangements, it would be advisable to do so whilst all DNs are in common ownership.

The question of the appropriate signatories for the UNC and consequent impacts needs to be fully explored and the risks assessed. For example, if Suppliers as well as Shippers were to sign, consideration would need to be given as to whether they should be full or restricted Users and whether they could propose change to all areas of the code or only those relevant to the supplier functions. Equally, if the suggestion of exporting SPA into the SPAA were to be progressed the implications of having Shipper and Supplier Functions under separate governance would need to be addressed.

(A.4) 2.3.3 Agency Arrangements

Issues to be addressed in designing and scoping an Agency:

- Who is to receive the service
- What will the service be
- Will all recipients require the same service
- Will the agency also provide services for the DNs and NGT NTS
- Will IGTs use the same service
- Who will pay for the service and how
- Who will provide the service and on what basis
- How will the service provider be selected
- How will change be managed
- Standards of Service
- Will the service include IS Development
- What happens if the Service Provider proves unsatisfactory
- How will costs be controlled
- How will disputes be managed
- Can the service be competitive
- Additions of new services in the future

In order to properly consider the above, it would be appropriate for all interested parties to meet and discuss their requirements, developing a joint scope which could then be used as the basis either for a competitive tendering process or the basis for a "special purpose" entity, as well as the Agency Contracts which would be required. This approach would take time, but would have the benefit of considering all contributions and leaving Industry participants with a high degree of confidence going forward.

In addition to the above points, we believe there are a number of other issues with the proposals, especially around the lack of detail provided and some of the obvious conflicts with current practice. A few examples are listed below:

- Lack of Detail
- Data ownership
- DM Metering and DM Meter Reading
- Management of File Formats
- Computer Systems – old and new
- Websites
- Financial issues such as credit and cash flows
- New Users
- Discontinuing Users
- Conflicts with Current Practice
- Interactions with the LDZs including siteworks and site visits
- Invoice queries – contrast experiences of querying Transportation invoices vs. Metering invoices
- Incident Management
- Co-ordination of site activities

(A.4) 2.4 Gas Balancing

In the body of our response, we referred to Common Systems Interfaces, TO/SO relationships and Neutrality.

(A. 4) 2.4.1 Imbalances:

The next group of questions relates to imbalances:

- How imbalances would be calculated and managed
- What trading impacts might result, especially in the area of locational gas
- Whether a zero tolerance regime would continue to be appropriate
- Whether imbalances might be tradable across DNs
- On what basis locational imbalances might be settled
- How would cashout prices be derived
- Whether cashout prices should reflect regional impacts
- The impacts on Title to Gas

(A.4) 2.4.2 Capacity Issues

British Gas also considers that the document does not address key issues around storage points; new, privately developed onshore entry points; development of new CSEPs or issues of inter DN measurement. In each of these areas there are significant implications in respect of capacity management, both for auctions and on a day-to-day basis.

The capacity issue highlighted above also leads to questions around treatment of capacity across the NTS/DN interface, how such capacity would be booked/allocated and paid for and how penalties such as ratchets and scheduling charges would be handled. A further issue for consideration is whether or not the quantities of capacity held on the NTS and the DN should be the same.

(A.4) 2.4.3 Forecasting and Demand Attribution

Fundamental to the operation of gas balancing for all parties is the management of forecasting and demand attribution processes. The document does not address many key issues in this area, and although NGT has stressed the least change nature of its proposals, in our opinion, however these tasks are managed, some change would be unavoidable. Particular areas in which we believe clarity is needed include how the following would be allocated between Transco NTS and the DNs:

- Generation of demand forecasts
- Demand Attribution
- The AQ Review processes (including EUCs and Load Factors)
- NTS and LDZ Shrinkage
- Temperature and Pressure Correction
- Maintenance of DMTS, NLT, NLRMM
- MEG Conditioning
- Calorific Values
- Weather Correction and Scaling
- Nomination Requirements

The issue of LDZ shrinkage (and the knock-on effects to RbD) is of particular concern. At present, a national factor is operated, which is adjusted using temperature and pressure information, to give proxies for LDZ Shrinkage Factors. British Gas believes that if one or more DNs are to be sold, such proxies are no longer adequate and that formal DN specific Shrinkage Factors are required.

British Gas believes that there may need to be fundamental review of the whole area of forecasting and demand attribution to avoid undesirable impacts on DN revenue. One example is the ability of Transco NTS to influence the collection of allowed revenue by DNs if it manages all the above processes: i.e. unless DNs were to change their Transportation Charging Methodologies, their recovery via DN Capacity and Commodity Charges would be dependant on the AQs and SOQs derived by Transco. This may prove unacceptable to any new owner of a DN, but divergence is likely to be equally unacceptable to the community.

A second example is regional variation in weather, leading to regional AQ variation year on year and potential over or under-recovery, which in its turn (via K) may lead to regional price variations and impacts to customers, independent of full geographical pricing. These impacts are smoothed at present due to the aggregate price control and common ownership, under separate ownership and controls, such impacts would be more visible and immediate (see 4.2 for more detailed discussion of this issue).

(A.4) 2.4.4 Operational Issues

There are a number of other operational areas in which we believe early clarification would be beneficial to the discussions including:

- Management of the Operational Guidelines and SMPS
- Top-Up
- Treatment of Operating Margins Gas
- Procurement Principles.

(A.4) 2.4.5 DNs as potential Trading Entities

This is a significant area, but in our view, it will prove difficult to move forward or comment on until greater clarity is available as to the way in which the networks will interact, including whether DNs are active SOs or sleeping partners to NGT SO.

If they are to be active on their own account it seems likely that some provision will need to be made to allow them to trade, at least in limited circumstances. If they are permitted to trade, they will require appropriate licence conditions and restrictions. Consideration will also need to be given as to how they will trade, for example, whether they would be limited to the OCM, whether they would be allowed to trade speculatively, and during what periods they might be allowed to trade.

If trading is permitted, we consider that they would also need to develop Procurement Principles, Tender mechanisms and to provide detailed accounting to the industry, to at least the same level of detail as is provided by Transco at present.

(A.4) 2.5 Portfolio Operations

(A.4) 2.5.1 SPA "support" activities

In addition to the activities which are associated with normal SPA transactions, we consider that the areas listed below would be very likely to be adversely affected by the Agency Arrangements, if sufficient time were not spent on detailed planning as to their future operation. During planning, we believe it would be key that all participants should be involved in the process. Many of these areas are complex and technical in nature, and will be managed operationally in a number of ways by participants.

- M-Number creation and allocation
- Query Management
- Dispute Resolution
- Transportation Pricing across multiple network operators
- Invoicing Management
- Invoice Validation
- Suppressed Reconciliations
- RbD Adjustments (see also 2.5.5)
- Transportation Credit Management
- CSEPs
- Section J Liabilities (Network Code)
- Estimated Opening Reads
- Daily Metering and Meter Reading, including telemetry
- Theft of Gas
- Primes & Subs
- NTS Connected Sites

(A.4) 2.5.2 Exit Reform and Interruption

As an active participant in the discussions to date around Exit Reform, we have already made a number of our concerns known, both verbally and in written responses. Without reiterating the detail here, we list below some points of principle which we believe to be key to the development of the regime:

- The physical operation of interruption must not be prejudiced
- Any change must preserve the flow of information

- Investment Signals
- Cross Subsidies
- Clarity on contracting parties
- Services Offered/Available
- Pricing

One further area which may prove especially significant with IDNs and RDNs in separate ownership is the penalty regime currently associated with interruption. At a customer level, failure to interrupt charges are applied, but at a shipper level the sanction of redesignating the entire portfolio as firm is open to Transco should there be repeated failures to interrupt. Depending on the shape of the regime going forward, it may be desirable to review this sanction.

We understand that HSE approval is required for a DN disposal, and that any new owner would need to submit a satisfactory safety case. Transco has previously asserted that the current levels of interruption are required for its safety case, so it is reasonable to assume they would also be key to DN safety cases. If this is so, it would be preferable to base safety cases on a stable regime rather than an untested, newly developed regime.

British Gas considers, on this basis alone, that the issue of Exit/Interruption reform should preclude the restructuring required for DN disposal until 2006/2007. It might even be better captured within the remit of the next Price Control, for the period 2007/8.

(A.4) 2.6 Other Issues

(A.4) 2.6.1 Pensions

Our main concerns in this area relate to the lack of information provided on which to comment. It is clear that there are considerable issues in relation to pension provision, both in respect of funding of retired members and the future retirees.

On the basis of the consultation document, we are finding it difficult to assess what the impacts on us (and hence our customers) would be. We do not wish our customers to bear inappropriate costs caused by choices previously made by NGT, and we welcome Ofgem's steer that Distribution Companies would not benefit from an automatic pass through of shortfalls.

In order to assess properly the proposals and whether pass through should be permitted, we believe more detail on the assumptions needs to be provided including: the ratio of actives to non-actives; the profile of business risk used in managing the funds; the basis for attribution of employees and assurances that the terms of pension provision would be carefully monitored during any divestment process.

British Gas also considers that publication of a report on the pension proposals produced by an independent actuary would assist consultees in formulating their responses to the document.

(A.4) 2.6.2 Solvency, Status and Termination issues

In recognition of the difficulties experienced by the industry in recent years, we are disappointed that more attention has not been paid at an early stage to these issues, we list below the key areas we believe require consultation:

Treatment of Insolvent DNs
Supplier of Last Resort
Cost Recovery for the proposals
Financial status of purchasers
Possible Undertakings for purchasers

(A.4) 2.6.3 LDZ Mains Replacement Programme

Ofgem has recognised a number of issues around the funding of the Mains Replacement Programme and has put forward some thoughts on how the issues may be managed. Whilst we agree that it would be possible for Ofgem to relax an individual network cap under the specified circumstances, we believe that this has clear implications for the costs customers face.

We believe that there are two scenarios to be managed, the first is where there is a regional underspend against the five year cap and the second where there is an overspend. In either case there is a transitional issue.

Customers historically will have borne a proportion of the costs of the network, as the cost was smeared, customers will have gained or lost over time. Going forward, depending on their location, customers will pay a greater or lesser amount depending on the costs of the network, as well as maintenance and replacement previously carried out. It is important that customers are not disadvantaged as a result of such historical accident.

In addition, if individual network caps are relaxed, this will result in the regions needing to collect extra revenue and hence creating additional pressure towards the rapid development of geographical pricing, as discussed in section 4.2.

(A.4) 2.6.4 LDZ to DN Mapping

In order to implement a DN sale, British Gas believes it will be necessary to map the existing LDZ (and possibly Exit Zone) fields in industry systems to the eight regional networks. We are not aware of how NGT plans to take this forward, but there would seem to be three main options:

- Overwrite the current LDZ field with the required DN
- Add a new field for DN
- Use a conversion table alongside the systems

The first option brings with it problems associated with synchronisation of change across the industry, timing and accuracy, whereas the second and third options would require systems development across all industry players. In all cases there would be issues associated with historical data and transactions. We believe this issue should be addressed as a matter of urgency as it will be key to the production of a robust RIA.

(A.4) 2.6.5 Transportation invoicing and Reconciliation by Difference

Although invoicing has been mentioned in passing in earlier sections, British Gas believes the issue is of sufficient magnitude to warrant separate consideration.

Currently the transportation invoices (LDZ Capacity, Commodity and some Ad Hoc invoices) are issued at various levels, either Supply Point, Supply Point Group or Exit Zone. Where Supply Point Group or Exit Zone is the criterion, the shift from LDZ to DN would be expected to require invoice amendment.

In the case of reconciliation by difference, the process is carried out across a series of sectors grouped by LDZ and relevant time period. Where LDZ is replaced by DN, the level at which RbD invoicing is issued will need to be amended.

In both cases above, we believe that if the DNs are to be separately owned, the invoices issued would need to be re-aligned to reflect ownership patterns. If RbD were to be amended in this way, transitional provisions would undoubtedly be required for a period of 18 months plus to reflect RbD run off. In addition, if prior period adjustments to RbD continue to be necessary (for example Mod 396 adjustments), the transitional provisions would need to remain in place for the duration of the adjustments.

(A.4) 2.6.6 Issues not identified or not addressed

In addition to the issues previously noted, British Gas has identified a number of other areas which we do not believe have been addressed in the document. We have listed examples below:

- Asset Related Issues
- Exclusion of Meter Assets from the sale
- Treatment of new entry points if developed and owned by the DN
- Duties of the Designated Registrar of Pipes
- Connections Policies for new sites
- Deep Vs. Shallow charging
- Mains Adoption Policies
- Precedence of NTS Vs. DN in decision making on new connections
- Cost Reflectivity and Cost Targeting – we believe some of the proposals may cause conflicts to develop
- Additional detail on Safety and Emergencies
    - How emergency services will operate
    - Issues around fragmentation of ownership between NGT Call Centres and DNs
    - Operation of communications and infrastructure.
- Gas Escapes
- Carbon Monoxide
- Incident Management and the duties of the NEC as impacted by the proposals
- Management of regular emergency exercises such as Jeopardy, Krakatoa and VIC tests.

British Gas believes that all these areas require detailed resolution prior to any DN Disposal.

APPENDIX 5: ADDITIONAL DETAIL ON CHAPTER 4.

(A.5) 4.2 Pricing

In the main body of the response, we discussed geographical pricing at a high level, but in addition to high level issues, geographical pricing would cause a number of other problems, some of which we list below:

- Impacts to customer billing systems
- Impacts to pricing models
- Increased difficulty for customers in evaluating offers, as DNs are not congruent with PES areas (we estimate 28 combinations for dual fuel billing as some DNs appear to overlap with up to 5 PES areas based on a visual comparison).
- Increased difficulties in revenue forecasting (currently smoothed by largely national prices and aggregation of demand)
- Impacts on invoice issuance
- Invoice validation will be more onerous

If geographical pricing is to be the way forward for the industry, it is a decision that should be consciously made, planned for and implemented, it is not a decision to be taken lightly or as a slightly unwelcome side effect of more fundamental change.

As previously mentioned, we believe a second order pricing issue becomes more prominent with the DNs in separate ownership i.e. the effect of the operation of the revenue restrictions. In other words, the difference between allowed revenue and actual revenue at a DN Level.

The LDZ price control contains a “best endeavours” obligation on percentage levels of accuracy on within year revenue recovery and provision for under or over-recoveries to be passed into succeeding years via K. We believe that the implementation of DN specific price controls will naturally be expected to lead to separate K factors.

Under an aggregate control and common ownership, the impacts of regional over and under-recoveries across the year are smoothed, when in separate ownership this effect is lost.

With separate price controls and separate ownership, if a region experiences under or over-recovery, depending on the level (and for whatever cause), either that region’s transportation charges will need to change within year, or they will change in the succeeding year due to K, or both. As it is highly unlikely that all regions would over or under-recover by exactly the same proportions, the probable effect is that the charges paid by shippers would vary regionally, potentially from April 2005 onwards.

As previously noted, customer margins are small, especially in the residential sector and hence it would be likely that such variability would be passed through in tariff charging, though it should be noted that such changes might be positive or negative.