



**National Grid Transco – Potential sale of network
distribution businesses**

Final Impact Assessment

A Response by British Gas Trading

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EXECUTIVE SUMMARY

British Gas Trading's ("BGT's") view of the project has not changed; in essence we are indifferent as to whether NGT should be permitted to sell 4 networks provided net benefits to customers can be assured. We believe that the Authority should not allow the sale unless they are satisfied that these net benefits will be delivered.

If the Authority consents to sale in January 2005, it seems likely that conditions would be attached. In any case, BGT considers it would be appropriate to plan a go/no go decision prior to hive down, such that if NGT has not fully met the Authority's conditions, DN sale is delayed. BGT would request that the Authority considers the following areas in its deliberations:

- Pass through of benefits

In the current proposals, customers will experience an adverse cost impact in the short-term, in exchange for unproven future benefits. One way of addressing this would be to re-open the price control to start the flow of benefits to customers immediately; alternatively, a figure should be stated in advance of sale (based on the Impact Assessment) for the reduction in allowed revenue which is directly attributable to DN Sale, to be passed through in the April 2008 controls.

- Attribution of Costs and Benefits

BGT believes the attribution of costs and benefits between DN Sale and price control separation must be fully quantified and either both must be removed from the DN Sale IA or both included. The current position, where costs are excluded and the benefit treatment unclear, is not tenable. The key consideration must be an accurate and symmetrical attribution of costs and benefits.

It is also relevant here to consider in more detail, whether the potential for benefits in the absence of sale has been properly assessed and discounted in the light of the additional information now available. In view of the lack of clarity, BGT considers that the risk of double counting benefits is high, and hence that there is a risk the IA may be flawed.

- Timescales

BGT believes that the timescales for the project are very challenging and continues to be concerned that the work which could be accomplished in the time available may be insufficient to be able to reach a firm basis for the net benefits of sale. Whilst this is particularly pertinent to UNC/GT Licence development/consultations, it is also true of implementation, as changes cannot be specified until legal drafting is complete. BGT considers that consultation periods should be set in accordance with the Cabinet Office guidelines for the remainder of the project. Achievement of a strong industry framework must take precedence over individual commercial drivers.

- Uniform Network Code ("UNC")

BGT's major concerns in this area are as follows:

- A number of issues raised in the detailed discussions have not yet been resolved, NTS Exit Reform details are not yet available and the transitional process remains unclear.
- Starting the consultation period prior to completion of the business rules is creating difficulties in achieving a clear overall view.
- The UNC is crucial to the industry; consideration should be given to extending the consultation period beyond the allotted 28 days rather than hurrying responses.

- Offtake arrangements

BGT continues to have concerns in respect of the correct placement of commercial, operational and technical matters in the UNC or ancillary documentation as mentioned in the response.

INTRODUCTION

This response to the Final Impact Assessment follows the consultation document for simplicity; hence the views of British Gas Trading (“BGT”) are given chapter by chapter.

BGT acknowledges the work carried out by Ofgem against tight timescales and the effort which has been made to provide additional clarity to respondents.

BGT remains concerned at the brevity of the consultation period allowed for a document of such current and future importance to the industry. Whilst it is acknowledged that there has been extensive debate during the project, and numerous meetings at which DN Sales have been discussed, BGT does not believe that this is a sufficient substitute for written consultation or that it justifies shortened consultations. Many organisations are not able to resource contributions to development programmes on the scale of DN Sales over and above existing workloads, and reducing timescales risks excluding the views of some parties. This point is particularly relevant given the concurrent consultations on the GT Licences and the Gas Act Exemption.

Whilst we accept that DN Sales is not an Ofgem initiated project, we believe that Ofgem should ensure that undue consideration is not granted to NGT’s commercial imperatives at the expense of customers and industry participants.

In addition to the above, a further area of concern is the preparation of a final Impact Assessment (IA) when there is a continuing lack of clarity around the detail and consequential costs of the future regime. It is BGT’s view that the IA cannot be considered complete, or fit for purpose given the significant uncertainties around NTS Exit Reform, the detail of the UNC and the GT Licences.

The document notes that the IA as it stands will be used by the Authority to inform their January 2005 decision on whether to give consent to DN Sales. BGT is concerned at the amount of information that will not be available to the Authority in January, and the additional difficulties this will present to the Authority in their deliberations and setting the requisite conditions on which their approval may be based.

In view of the shortened timescales and the continuing lack of clarity around key aspects of the proposed regime, BGT wishes to reserve the right to make additional representations should presently unforeseen consequences, costs or benefits become evident.

Responses to views requested by chapter

Chapter 4, Key Issues

Key issues arising in relation to the potential benefits of DN Sales:

BGT agrees that the key benefit of DN Sales is the introduction of comparative regulation, we would also note, but do not fully agree with, Ofgem's previous assertion that the majority of benefits of comparative regulation could be obtained from the separation of the price controls and robust licence conditions.

With this in mind, we believe that the benefits of comparative regulation ascribed to DN Sales have been overstated. As has been explained previously, we are of the view that the benefits of price control separation should be properly quantified and subtracted from the benefits described under DN Sales. It is essential that either the costs and benefits of price control separation are included, or both costs and benefits should be excluded, otherwise the comparison is not on a like for like basis. Whilst it appears that a small allowance for price control separation may have been excluded, this is not clear, neither is the basis for the quantification. We do not refer to costs at this point, as the costs associated with price control separation have not been included within the IA. BGT would welcome further clarification on this point to provide reassurance that the potential benefits have been properly attributed.

BGT also agrees that the introduction of separate management teams may be beneficial, but doubts the extent to which this is likely to be realised in the short to medium term; perhaps for the remainder of the current price control period, given that many staff are likely to be acquired as part of the sale process and that the Safety Cases and SOMSA operation might be expected to provide a high degree of continuity by definition.

With respect to the potential for improvements in the economic and efficient operation of the networks, BGT agrees that this may prove to be the case. However, given that NGT has been for many years a price controlled, regulated monopoly, we believe that the ongoing operation of the price controls should have already provided a sufficient incentive for NGT to optimise their network operations.

Finally, BGT doubts the potential for DN Sales to promote competition in wholesale and retail markets. We are of the view that DN sales and the accompanying changes will significantly increase complexity in the gas industry, not least in pricing, and increase costs of operation, with this in mind, we believe that whilst the effects on competition could, with the right industry framework, be neutral, they are unlikely to be positive. It is conceivable that this may have been a factor in the noticeable movements of some players within market sectors.

Key issues arising in relation to the potential costs of DN Sales:

BGT agrees that many of the key issues in respect of potential costs have been identified, and that considerable efforts have been made to address both the costs and underlying concerns. One of the key risks of the proposals has always been the inefficient fragmentation of Shipper interfaces. BGT agrees that the Agency proposals, especially the compulsion on the GTs to use the Agency, go a long way towards mitigating the most severe effects in this area. However, there are a number of significant areas, including siteworks, connections and metering, which are not included within the remit of the Agency, and the potential impacts and complexities should not be underestimated; for example, added complexities around connections and Siteworks may result in some participants scaling down or withdrawing their activities in these markets.

We also note that costs associated with NTS Exit Reform cannot be properly quantified at present, as the business rules are still in development and the first auctions are not expected to take place until spring/summer 2005. Additionally, the initial understanding that the transitional arrangements would involve "minimal change" does not now appear to be the case. With this in

mind, the risk that the costs may have been understated seems material. Of equal importance is that significant up front and ongoing costs associated with DN Sales are guaranteed, whether one or more DNs are sold. The benefits of DN Sales at this stage are far less certain, and will, in any case, not start to flow until at least 2008 given Ofgem's reluctance to re-open the price control.

BGT also believes that, as stated above, these proposals, due to their cost and complexity, are unlikely to benefit competition, and we continue to be concerned that they may prove harmful.

Chapter 5, Options

Allocation of roles and responsibilities:

BGT agrees with the division of the roles and responsibilities as described in the document, i.e. the Active DN model, but remains concerned to ensure that the proposed industry framework properly captures key interface issues. For example, we appreciate that many technical interface issues may appropriately be dealt with on an operator to operator basis, however, BGT also believes it is essential that any issues which may impact on the commercial or operational arrangements in the industry should be captured in the UNC, and be modifiable by signatories, rather than being included in ancillary documents. BGT is not yet persuaded that this division has been properly achieved.

Offtake Arrangements:

BGT both welcomes and supports the decision previously made to decouple DN exit reform from the DN sales process. However, we would welcome clarity on the mechanism by which DN Exit capacity will be booked as we understood no change should be expected in this area, this is not borne out by the IA. At present, the equivalent activity to DN exit capacity booking is carried out automatically by NGT based on supply point registration, however, 5.57 indicates that shippers would submit requests to DNs by DM sites and NDM zone. We also believe that further clarity is needed in areas such as DEC overruns, the attribution of which between shippers has not yet been fully explained.

In respect of the proposed NTS offtake arrangements, including NTS Exit Capacity auctions and the flow flexibility product, BGT continues to believe the arrangements in respect of NTS Direct Connects are overly complex and are likely to prove costly and unworkable in practice. It is not practical in the current environment to expect shippers (on behalf of NTS customers) to be able to make a financially firm commitment to purchase capacity and flow flexibility for specific customers 3-15 years out, when the normal length of a supply contract is 12 months. We are also of the view that the arrangements described to date will not meet the needs of storage points and interconnectors.

The document reflects the change in Ofgem's previously expressed views on whether or not legal separation of the NTS and RDNs should be required if Authority consent was granted. This change appears to be mainly influenced by the assertion from NGT that it would incur greater costs. BGT continues to believe that legal separation should be required and that targeted structural separation alone is significantly less robust. The proposals to sell DNs are a commercial initiative by NGT, and as such, the costs of business separation should have been factored in to the business case for sale.

If the Authority continues to believe that full legal separation is not justified, we are of the view that a greater degree of transparency of the separation arrangements will be needed to provide the industry with confidence as to the efficacy of the arrangements. The document makes little reference to business separation between RDNs (and for that matter, IDNs), but we believe that these separation arrangements should also be transparent and robust. We would further recommend that Ofgem should require the RDN and IDNs to be independently audited on their separation arrangements and to provide appropriate reports to the Authority.

BGT agrees that if the arrangements for NTS Exit Capacity described in the document are implemented, then clear, simple, transitional arrangements will need to be in place. To mitigate costs, these transitional arrangements should be based on minimal or no change to users and customers as had been originally understood. As stated above (Ch. 4), the transitional arrangements for Exit and Flow Flexibility proposed by NGT appear to be unnecessarily complex.

BGT supports the establishment of the Agency to mitigate some of the risks associated with DN sales, but continues to regret that a range of ancillary agreements, including siteworks, connections and metering are not included, as this would provide an opportunity to mitigate significant extra cost. If fragmentation in these areas is deemed desirable, this should be the subject of a separate debate and IA at a future date and not bundled with the DN Sales process.

BGT also supports the development of co-ordinated arrangements to manage the administration of the network codes modifications processes and charging methodologies. BGT has concerns in respect of how the actual modifications processes will work, in the light of NGT's proposals for the joint office and its governance.

Chapter 6, Potential competitive, environmental and social impact

BGT broadly agrees with the assessment of the likely impact of the proposals on small firms and the environment. In respect of the assessment on small firms, we are concerned that the impact of the proposals may be damaging to small shipper/supplier businesses, as we believe that this may be more serious than it at first appears, as such impacts may act as a significant barrier to future market entry.

In respect of the wholesale markets, we recognise that Ofgem has tried to ensure the continuity of the current arrangements. We also welcome the importance attached to ensuring that Shippers and Suppliers should not have to engage in different processes in order to transfer customers situated on different networks. Even so, we are still concerned that the proposals may have a detrimental impact on competition simply as a result of complexity and increased costs of operation in the markets. Whilst the majority of the concerns expressed to date relate to the impacts on shippers and suppliers, BGT believes that the proposals will also have a considerable impact on IGTs, who will have to interface with multiple transporters and compete with them.

Chapter 7, Risks and unintended consequences

BGT agrees with Ofgem that the key risks of the proposals are that the benefits are not (fully) realised and that the costs may be understated. There does not appear to be any provision for ongoing monitoring of the success of the process and review of the benefits achieved.

As previously noted, even with the current degrees of uncertainty, the costs can be more confidently predicted than the additional benefits which may arise as a result of DN sales. The costs are up front and ongoing, and the benefits will have to be driven out via future price controls. The benefits are inherently more difficult to predict accurately and verify than the costs, which can be assessed with a fair degree of certainty once the details of the proposed regime are known. BGT is also of the view that it is important to correctly attribute causes of both costs and benefits, and we continue to have concerns that benefits may be double counted in the absence of a clear assessment of the benefits achievable by price control separation alone.

NGT in its initial RIA referenced a report prepared by Accenture and concluded that “the potential merger synergies available to a trade buyer are 19-26% of controllable opex. This level of savings reflects what a buyer can reasonably be expected to deliver in the first 3 years following the transaction.” The components of these percentages being described as

performance push savings (10-13%) and combination synergies (9-13%), the latter of which are not available to NGT. The clear corollary to this is that the balance of these savings should be available in the absence of DN Sales. This does not appear to be reflected in Ofgem's assessment of the benefits.

BGT also agrees with the areas in which Ofgem believes there may be unintended adverse consequences, and would add the risk to Shipper and Supplier businesses, as well as the potential increase in the barriers to market entry.

Chapter 8, Analysis of benefits

BGT has carried out and commissioned considerable work in this area, and remains unpersuaded of the degree of benefits that can be ascribed to DN Sales alone. We also note that the positioning of the benefits to customers appears to have shifted during the process from actual benefits to no detriment. In addition to the above, we observe that in Ofgem's view, the benefits to customers are likely to be such that comparative regulation could reduce the costs of gas distribution relative to a no sale scenario; i.e. that charges payable by customers should be lower than they would otherwise have been. This is very different to costs to customers actually falling.

Ofgem has not quantified likely capital savings and due to this (among other reasons) describes its approach as conservative. BGT is concerned that if such benefits exist, they need to be quantified as early as possible to lay the ground rules for achieving price control cuts in this area.

We note that Ofgem's application of the exogenous and endogenous approaches has produced similar results, but would note that any methodology is dependent on the assumptions used, and that application of a different set of assumptions may be expected to produce very different results. Overall, given the relative simplicity of the exogenous approach, BGT is inclined to believe that this may prove a more practical way forward in this case. We would, however, wish to stress that this approach should not be allowed to lead to more relaxed targets than might be the case under the endogenous approach.

In paragraph 8.28, Ofgem notes that under the no sale option, the targeted rate of improvement may be marginally tougher than has historically been the case for NGT as a result of the separation of the price controls. We would urge Ofgem to quantify this effect more stringently, and further to use the information which has been produced by NGT as part of this process to tighten the baselines to which all GTs must work, should Authority consent be granted. We would welcome further clarification to demonstrate that this has been adequately reflected in the benefits case for sale. Paragraphs 8.37 - 8.41 also support this point.

BGT is also concerned with respect to the implication that lack of evidence for the presence of economies of scale may be seen as evidence for diseconomies of scale, and hence sale may lead to increased efficiencies on NGT's contiguous networks. We do not believe that in the absence of sale, NGT cannot achieve economies and efficiencies of scale.

With respect to the profile for benefits flow, we are inclined to agree that a bell shaped profile seems most likely, but we are concerned that starting this bell shape in 2008 may lead to delays in customers receiving benefits and indeed reduced benefits due to the activities of the GTs post sale. If a bell shape is to be employed, we believe that it should start from sale (notionally, if the price controls are not to be reopened) such that by the time the next price control starts in 2008, the benefits flow to customers is reaching its peak. We believe this is both practical and reasonable, as based on the current published timescales, this would allow the GTs almost 3 years to climb up the curve.

Chapter 9, Analysis of Costs

Overall, BGT is encouraged by the way that Ofgem has tried to address participants' concerns in respect of costs. However, we do believe that impacts have been underestimated in some areas. We are also concerned at the significant reduction in costs before certainty on the regime to be implemented is achieved.

Roles and responsibilities:

We disagree that the allocation of roles and responsibilities would not have a material effect on shippers, as we believe that the activities of the GTs in the way they interact and manage their networks does have the potential to place additional costs and risk on shippers, for example in the areas of constraint management and balancing.

Governance and Agency

BGT agrees that the establishment of a robust agency and the compulsion on GTs to use it does mitigate the potentially enormous costs, which would be associated with fragmentation in this area. However, we believe that elements of the proposals have been underestimated, for example the costs associated with Siteworks, Connections and Metering, as well as the costs associated with NGT's proposals in respect of the Joint Office (reference the paper presented to DISG 16).

NGT has received allowances for the administration of code modifications as part of the current price control, however the proposals suggest that the burden of the work should fall upon the proposer in respect of modifications. If this is the industry's preferred way forward, and BGT is not yet persuaded that this is an agreed position, then the current price control allowances should be removed from the implementation date. BGT is also concerned that the NGT proposals in respect of information provision and report preparation by modification proposers, plus the restrictions on activities of Subject Matter Experts may lead to discouragement or the effective exclusion of some participants from the process.

BGT continues to have concerns about the increased costs which may result from the fragmentation of the Metering Provider of Last Resort ("MPLR") and resulting from the move to a one to many relationship with multiple DN Owners, the increased complexity inherent in identifying the correct DN at network boundaries and the possible divergence of communication protocols. The same issue also arises in respect of connections provider of last resort.

In addition to the MPLR issue described above, BGT is not yet convinced that the arrangements in respect of emergencies (apart from the operation of the 0800 number) are sufficiently robust given the licence requirement to "make safe" as opposed to maintaining supply, and believes further discussion and assurance on this point is needed.

We have also previously raised the point about lack of clarity on the booking arrangements for capacity booking at a DN level, and we would request this is urgently clarified. In our view, if Shippers' role is expected to change, as appears to be indicated in the document, than additional costs will be incurred.

Offtake Arrangements

BGT is firmly of the view that, in the absence of available detail on exactly what will be implemented in respect of NTS Exit Reform, these costs have not been properly evaluated. Given the complexity of the proposals, we believe that it is very likely the costs to shippers have been underestimated. In addition, if shippers are required to purchase capacity and flexibility on behalf of customers more than 3 years out, or face the "prompt" market, we consider that this changes the risk profile faced. BGT also considers that the current transitional proposals include an unnecessary, and potentially extremely costly, level of complexity.

We believe that the costs incurred in respect of the NTS Direct Connects, both by customers and shippers are likely to be underestimated and do not reflect the increased risk (and potentially expense) of meeting their transportation needs under the new regime. These costs will ultimately be borne by consumers and in the case of a number of these connected supplies, may impact on the power sector.

Estimate of likely costs to shippers and suppliers

BGT wishes to re-iterate its concerns about the process applied to the collection of cost estimates, we continue to believe that the time allowed for such an important activity was inadequate, and that in the absence of detailed specifications, such estimates must be subject to revision by the provider.

We are concerned at Ofgem's approach in reducing these estimates given the degree of uncertainty as to the current regime which persists and the minimal time given to respond. Whilst we note that Ofgem has not excluded allowances for contingency, we are very concerned at the implication that such allowances are not a necessary item on a project of this size. Normal practice would indicate a contingency fund of around 10%.

BGT believes that it would be advisable to review the cost case once all relevant details of the new regime are known, as the overall cost benefit position can only be judged when the details of all the commercial arrangements are known and assessed. BGT is also of the view that if new evidence on costs or benefits becomes available after the Authority decision, the re-opening of the price control should be reconsidered.

Chapter 10, Results of the Cost Benefit Analysis

As has been described above, BGT remains concerned about the estimation of the costs and benefits in the IA, though we acknowledge the improvement over the earlier IAs.

In the absence of greater certainty on some areas of the new regime and hence implementation costs, we are not yet persuaded that the cost estimates used will be robust, though clearly the Agency has done much to remove significant costs from the equation.

We are also unconvinced that the potential benefits ascribed to DN Sale have been properly attributed as we consider that there may be double counting between the benefits of DN Sale, and benefits which should, more properly, be ascribed to price control separation.