Cheung Kong Infrastructure/ United Utilities Consortium

Response to the Final IA

Introduction

Our consortium welcomes this consultation and is strongly in favour of the sale of DNs. The Final IA is the culmination of a series of RIAs that have set appropriate incentives and frameworks to maximise the benefits, both quantitative and qualitative, and to minimise the costs and complexity associated with DN sales. This is an opportunity to break up a monopoly provider and to inject the competitive tension that has led to significant benefits within the UK electricity and water sectors.

This response provides a summary of our views and then sets out a more detailed response against each of the chapter headings within the Final IA.

Summary

The water and electricity industries in the UK provide clear evidence of the benefits to customers of having comparators, for example the 45% operating efficiency gap between Scottish and England & Wales water companies. These benefits may arise from comparative competition or from the inefficiency of a sole monopoly provider. The sale of four DNs by NGT is a unique opportunity to introduce these benefits into the gas industry and at the same time introduce reforms that should make the industry more effective, efficient and innovative.

Specific benefits will arise from areas such as:

- four diverse operating models;
- the introduction of new management teams;
- innovation in organisational structures, asset management and asset operation;
- sharing best practice across utility networks;
- synergies from existing operations; and
- improving the information that Ofgem has to regulate the industry.

There should also be additional benefits for customers from innovations to improve customer service, connections, safety and offtake arrangements, and also from the new agency and the governance body.

We concur with Ofgem's analysis of the benefits and we believe that Ofgem has erred on the side of prudence (ie estimated high) when assessing likely industry costs. We do believe that the underlying rate of cost improvement by Transco over the next 18 years would not have been as high as 3% each year, but this does not affect the overall estimate of benefits. Hence we agree with the conclusion that the net customer benefits of DN sales will be about £225m. We agree that a bell-shaped curve is the most likely way that these will be delivered to customers; in particular as there will be insufficient data in the early years on which to place significant reliance.

Furthermore, we believe that DN sales will encourage other innovative practices leading to improved customer service and safer ways of working. Benefits to the wider UK economy will be positive as both small firms and fuel poor customers will benefit from lower gas costs.

Over the last year, Ofgem has undertaken an extensive and transparent consultation process involving all market participants with a view to mitigating the risks arising from separation of the gas networks. We believe this has resulted in a series of decisions, such as the allocation of roles and responsibilities (eg retaining centrally supply point administration and the uniform network code) that mitigates these risks and helps ensure that the identified benefits will be realised.

Section 4 – Key issues

Potential Benefits

The opportunity to compare companies has provided significant benefits for customers in both water and electricity. For example, in water the Water Industry Commissioner for Scotland in his 2002-2006 Strategic Review of Charges identified an operating efficiency gap of around 45% between the Scottish water companies and the England & Wales water companies. This can be argued to be as a result of efficiencies achieved in England & Wales since 1989 due to comparative competition and the underlying inefficiency of a sole monopoly provider. Similarly, the CEPA study quoted in appendix 6 shows that DNOs have achieved 2.8% greater opex reduction than NGC.

The sale of DNs provides significant opportunities for providing benefits to customers. In particular, NGT, as a monopoly provider, has little incentive to identify new and innovative cost efficiencies or to change ways of working to improve competition. The benefits will come, for example, from:

- The diversity of operating models, where it appears that the four DN owners may well have four quite different operating models, each one of which is likely to result in different pressures and opportunities to identify efficiencies.

- New management teams, which will bring new ideas into the industry and should provide a significant impetus to the slow shift away from the bureaucracy and non-commercial outlook of a once nationalised industry.

- The greater incentive and opportunity to innovate, and also a wider range of potential innovators. Innovation could come, for example, in organisational structures, asset management, asset operation, running the Agency, pricing structures etc.

- Sharing and development of best practice. For example, the North gas network provides an opportunity to transfer the best practice and asset management skills gained from the water and electricity businesses.

- The reduction in informational asymmetries between gas DNs and Ofgem by the access that Ofgem will have to a greater breadth and depth of information.

However, it is worth noting that these cost reductions are not necessarily absolute, but is only in relation to the position with no DN sales. For example there may be external cost pressures, for example pensions and road pricing, that will impact DNs in both a sale and a no sale scenario.

Benefits will not only occur in direct cost reduction, but also from innovations in identifying ways to improve customer service, developing safer ways of working within the industry and from more efficient and effective offtake arrangements and demand forecasting. For example, Ofgem will be able to establish benchmarks in service standards through incentive arrangements like the IIP scheme in electricity. Furthermore, new management is likely to result in improvements in connections where Transco has been subject to an enforcement order for several years as a result of poor performance.

The new arrangements within the gas industry are likely to produce other benefits. In particular, the opportunity to develop new offtake arrangements should lead to improved pricing signals and more effective wholesale gas competition. Furthermore, the new governance body and agency introduce new and diverse management which is likely to accelerate the pace of innovation.

Potential costs

We do share some of the concerns that Ofgem raises about discrimination in particular for NGT to favour retained DNs. In principle, we are comfortable that robust separation requirements can be established in the licence and effectively monitored to help mitigate these concerns.

There are clearly additional costs for shippers as discussed in section 9, but both the cost and the complexity of the new arrangements have been mitigated by the creation of the agency to ensure shippers continue to interface with a single entity.

There should be minimal impact on wholesale and retail competition as the creation of the agency retains the single user interface for shippers and National balancing Point arrangements remain unchanged. It is noteworthy that supply competition in electricity, where there are multiple electricity network owners (and a legally separate transmission owner) has been at least as effective as that in gas.

We are also comfortable that security of supply will not be threatened. Ofgem has determined clearly defined roles and responsibilities between GTs. The stringent HSE requirements on approval of safety cases provides opportunities to <u>improve</u> safety and security of supply by developing new, best practice frontiers for safety.

Section 5 – Options

Roles and responsibilities

We support the proposed allocation of roles and responsibilities as it ensures that a DN owner has as much control over meeting its statutory and licence obligations as is practically possible. This provides two main benefits:

- **Accountability.** This allocation places accountability for operation and planning functions for each network with the network responsible for delivery. This may enable a DN to innovate in the way that it carries out system planning, supply/demand balancing and control of gas flows. Alternative options could potentially lead to a highly litigious environment given the blurring of accountability and responsibility. This could increase contractual complexity, lead to disagreements and disputes that would necessitate regulatory involvement and involve additional expense across the industry which would ultimately be borne by the consumer.

- **Efficiency.** The greater the degree of control and responsibility that a DN owner has over its operations the greater the scope that DN owner has to operate and manage its business more efficiently and economically. This has clear benefits for shippers and consumers through improved services and reduced costs.

Offtake

In principle, the offtake arrangements should provide opportunities to improve network investment decisions as these give the DN prime responsibility for the capacity booking process which should enable both the DNs and Transco to take the best informed decisions regarding the economic and efficient development of their respective networks. However, there is a significant amount of detail to resolve in the whole area of exit reform. If this is separated from DN sales then there is considerably more likelihood in sales with no timetable delay, but there should be no significant impact on competition.

It is unclear that an auction in which there is only one bidder will provide true market signals. Furthermore, although we fully support the arrangements proposed for booking NTS exit capacity, there are still some outstanding issues that require clarification to enable us to fully commit to the offtake arrangements:

- the baseline capacities and baseline flexibility that will be made available;
- the exchange rates will apply when exit services are traded and the methodology for determining them;
- clarification of the rights that DNs have when bidding for exit services and their ability to trade those services – ideally confirmation of exclusive rights to enable management of the risks associated with acquiring exit capacity;
- the reserve prices that will apply to the exit services; and
- the detailed incentive regime that will apply to DNs.

We are unable to comment on the suitability of an annual allocation without having certainty on the ability of the DN to acquire and trade exit capacity. It is difficult for us to comment on the suitability of a nodal model until there is more clarity on the price and availability of capacity.

Diurnal storage and operational flows

We believe that the flexibility product is an overly complex way to reform the offtake arrangements at this stage. The work that is required to fully implement this may impact the timetable. Consequently, in the short term, a more transparent rule-based product may be more appropriate.

Business Separation

Ideally, there would be full legal separation of the RDNs and the NTS to ensure no undue discrimination. However, we recognise the issues that Ofgem raises that would arise from legal separation. Consequently, we agree that there should be full structural separation of the RDNs and the NTS. We would welcome the development of a set of licence conditions, as proposed in 15.14 to 15.19, to ensure that Transco separated its business as far as practicable. Furthermore, it is essential that there is close scrutiny of NGT's cost allocation methodology to ensure that there is no cross subsidy between RDNs or between the NTS and the RDNs and that robust monitoring arrangements are in place. These measures should help ensure no undue discrimination in favour of RDNs and hence that DN sales provide maximum benefit to customers.

Short term arrangements

In paragraph 5.91, it would be helpful if Ofgem could confirm that the statements in the first bullet point are only applicable to NTS direct connects and not to DNs. NGT stated at the ERF of the 8th December 2004 that DNs will not be purchasing NTS exit capacity in the short term arrangements but will in fact be allocated offtake rights in line with the exit capacity that already forms the current plans and has already been agreed between the NTS and the DNs.

We fully support the confirmation given by NGT at the ERF that shippers will book and pay for NTS exit capacity as in the current arrangements.

Agency

The development of the Agency has been an important step in minimising cost and complexity for shippers. Continuing to have a single interface should ensure that there is not industry fragmentation. Transfer of responsibilities to the agency minimises the duplication of systems and processes required as a result of DN sales whilst ensuring that DNs manage functions required to retain control and maximise outperformance opportunities. Furthermore, the injection of new and diverse management into the agency should provide opportunities for improving the service that it gives and identifying more efficient ways of working.

Governance

The Joint Office governance arrangements provide a consensual approach to managing the UNC and should enable UNC development in the interests of each of the parties involved.

Section 6 – Potential competitive, environmental and social impact

We reiterate the comments made in our response to section 4 that DN separation should provide significant benefits to gas competition through comparative regulation. There will also be more financial information available on relative performance of DN owners which will enable shareholders to exert pressure on companies either to outperform Ofgem targets (for the ultimate benefit of customers) or to be taken over by management teams that can better drive out efficiencies.

We believe that the impact on the wholesale market is positive with the agency minimising costs and fragmentation and the new offtake arrangements providing greater flexibility. This in turn will enable gas retailers to be more innovative in product development and pricing and help stimulate retail competition.

We concur with Ofgem that the impact on small firms overall will be positive due to the lower gas costs that will result from DN sales and comparative regulation. Additionally there should be no material environmental impact. Fuel poor customers will clearly benefit from lower gas bills.

Hence overall the impact will be strongly positive on competition and socially beneficial.

Section 7 – Risks and unintended consequences

Ofgem notes that there are risks in achieving the benefits due to informational asymmetries. These will be greatly reduced following DN sales because Ofgem will have the opportunity to receive information from four organisations, each with different business models, rather than from one. The opportunity to compare information across DN owners will undoubtedly improve the quality of information available and will reduce the lack of detail that arises from the impact of allocating a large pot of central costs across NGT's 8 owned DNs. As is currently happening in the electricity industry, there will be opportunities over the next few years for Ofgem to refine its information requirements as it gains greater clarity of costs, thereby improving its ability to reduce costs through comparative regulation.

We are comfortable that the risks associated with the costs of DN sales have been carefully considered by Ofgem and substantially mitigated through the consultation and decision process throughout this year. Ofgem will clearly continue to closely monitor the operation of the gas market to ensure that risks don't materialise. In particular the structural separation of the NTS and the RDNs, and the licence condition on Transco not to discriminate in favour of RDNs help minimise these risks. Our responses to the risks identified are provided below:

- Fragmentation of the wholesale market is extremely unlikely as the division of roles and responsibilities together with the proposed offtake code will create the appropriate accountabilities and incentives on the NTS and DNs to ensure operational efficiency.

- The licence conditions for common agency arrangements that act in customers' interests will ensure that the agency is effective and stays in place, at least until such time as a cost benefit analysis demonstrates preferable alternative arrangements.

- The Joint Office will ensure timely and effective modifications minimising the risk of delaying or blocking modifications that benefit customers.

- The licence condition on NGT not to discriminate in favour of RDNs is a powerful incentive to ensure effective and efficient offtake arrangements.

Section 8 – Analysis of benefits

Our response to section 4 summarised the benefits that comparative competition can bring. We are broadly comfortable with the assumption of an additional 1.13% cost reduction p.a. as a result of DN sales. Consequently we agree with Ofgem's calculation of the benefits to be derived from additional efficiency savings as a result of DN sales.

There are likely to be some losses from diseconomies of scale, but we believe that these will be modest in comparison with the scope for greater efficiency. Furthermore, Transco is a huge monolith with all control at the centre, which has resulted in a distancing of many of the functions from the operational units. The IDNs will have much shorter spans of control between the organisational centres and the operating unit resulting in operational benefits. NGT's reorganisation of its RDNs into one operational unit will significantly improve the opportunities it has to identify and extract economies of scale.

However, we do have a concern about the assumption that Transco could have reduced its costs by 3% p.a. for the next 18 years if it had remained as a stand-alone company. We do not believe that this would be achieved were Transco to remain as an integrated gas transportation company, in particular as it has already substantially reduced costs in the 18 years since privatisation. Ofgem's Final Proposals assumed 1.5% p.a. reduction in controllable costs for DNOs 15 years after privatisation and Ofwat's Final Determination assumed 0.8% p.a. (of which only half has been included as a target in setting price limits). A change in the assumption of an annual 3% cost reduction for DNs under a no sale option, though, will not materially change the net benefits associated with DN sales.

We welcome Ofgem's assumption of a bell shaped curve in delivering these cost reduction benefits to customers. We agree:

- firstly that there may be insufficient data to achieve significant cost savings in the 2008 review, in particular it may be dangerous to rely too heavily on the implications of an initial benchmarking exercise;

- secondly that opportunities will be greatest in 2013 when innovation and the diversity of management styles should have provided more significant movements in the efficiency frontier; and

- thirdly that the easy to achieve efficiencies will have been undertaken by 2013 and that lower efficiencies are likely to be available by the 2013 review.

Merger policy

Ofgem's analysis clearly shows substantial benefits to customers even if there were only two DN purchasers. Consequently, it is not clear that there should be significant penalties applied in the event of a merger of two DNs. In particular, we do have a concern that when evaluating the potential detriment to customers, Ofgem intends to assume the benefits to customers are as per the high case rather than the base case. Ofgem's analysis of merger benefits suggests that it believes that single DNs incur higher costs than multiple DNs and consequently we would expect this to be recognised in price reviews.

We assume that, were there to be a transfer of some (but not all) DNs from one DN owner to another, then there would be no penalty as there would be no loss of comparator and hence no customer detriment.

Section 9 – Analysis of costs

We do not feel that we are in a position to comment substantially on potential shippers' costs. However, we note that it is unlikely that shippers have underestimated the costs that they are likely to incur and hence the outturn PV of costs is more likely to be lower rather than higher than £101.9m.

Section 10 – Results of the cost benefit analysis

In summary, we agree that Ofgem has used realistic, if not conservative assumptions for the benefits, the costs and the assumed discount rate and that consequently £225m is a reasonable estimate of the net benefit of DN sales.