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16 December 2004

Dear Sonia

**Final Impact Assessment – NGT Response**

Please see attached NGT's response to Ofgem's Final Impact Assessment on the proposed sale of four of NGT's Gas Distribution Networks.

Yours sincerely

Chris Train
**Director – Network Sales**

## Final Impact Assessment – NGT Response

## Executive Summary

### Overview

We welcome the opportunity to comment on Ofgem's Final Impact Assessment (FIA) relating to NGT's proposed sales of four gas distribution networks (DNs). Overall, we support the sale option, not only because it facilitates our transaction, but also because it has the potential to deliver real and significant benefits to customers both in terms of lower transportation charges and by way of improvements across all aspects of service delivery. We also believe that the proposed commercial and regulatory framework detailed in the FIA will serve to minimise the scope for costs and disruption to shippers and consumers resulting from the sale.

We believe that existing and future consumer interests would be protected in the event of the sales, with the potential benefits significantly outweighing the associated costs. Accordingly, we consider that the no sale option would represent a significant lost opportunity for consumers. We therefore urge the Authority to consent to the proposed sale, as we believe this would be consistent with its duties to protect the interests of consumers.

### Analysis Of Consumer Benefits

Following a detailed review of Ofgem's assessment of the consumer benefits of DN sales, we consider that Ofgem's methodology is robust and support its base case estimate of £325 million in gross consumer benefits.

The sale would allow Ofgem to compare performance between gas distribution networks in setting price controls, emulating the proven approach successfully adopted for the electricity distribution and water sectors[1]. Information on best practice and financial performance of regulated utilities in these sectors has provided regulators with benchmark information to identify performance targets that are more challenging than would have otherwise been possible, thus benefiting customers. This approach has created the incentive for network owners to outperform relative to their peers, further pushing forward the frontiers of financial performance. There is every reason to believe that comparative regulation in these sectors can be equally replicated across the gas distribution sector, thus delivering similar benefits to customers by way of reduced gas distribution prices.

Furthermore, we believe that innovative new management styles and ideas introduced into the industry as a result of the sales will push the frontiers of best practice in service delivery. The consequential effect of comparative competition will provide strong incentive for DNs to keep up and strive to outperform their peers in this respect, with customers ultimately benefiting from an enhanced level of performance and customer service.

Ofgem's consumer benefits estimate is focused on the potential for savings in the DNs' allowed operating costs resulting from comparative regulation, and the benefits of reform in the offtake and interruptions regime.

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[1] *When considering same-sector mergers, the DGWS has consistently argued that the benefits to customers of comparative competition between separately owned companies are considerable; more detail on the DGWS' assessment of the benefits of comparative regulation and its implications for DN sales were provided in NGT's response to Ofgem's RIA in November 2003.*

We support Ofgem's methodology and assumptions for estimating consumer benefits, but would suggest that the following elements could also be taken into account when considering the overall impact of DN sales on consumer benefits:

- The assumption of a 3% ongoing annual reduction in controllable operating costs in the no sale option appears aggressive, considering Transco's allowed controllable operating cost reduction is 2.5% in the current price control period and was 3.8% in the period prior to that;
- Whilst we support the 6.25% discount rate used by Ofgem to calculate the present value of consumer benefits, we believe that there is a case for using a discount rate that is more closely aligned to the cost of capital of the average consumer (e.g. the DTI used a more appropriate 3.5% social discount rate) rather than the cost of capital of the GTs;
- DN sales can also be expected to benefit consumers through efficiencies in capital and replacement expenditure and improved customer service.

Applying these factors to the methodology presented in the FIA could be used to demonstrate a stronger consumer benefit case from the sales.

**Analysis of Industry Costs**

Whist we consider the assessment of up-front costs to be reasonable and broadly consistent with our own estimates, we believe that ongoing costs presented in the FIA may be overstated.

We believe that ongoing incremental costs will not be significant, largely due to the development of the Agency concept, maintaining a common interface to shippers and suppliers and minimising process changes. Due to the uncertainty over how the new commercial and regulatory regime that will be established to support the new industry structure will affect the industry, we believe that many industry parties will, understandably, have been conservative when assessing the cost impacts. In our view, the present value of costs to the industry associated with DN sales will be somewhat lower than the estimate of £101.4m presented in the FIA.

**Overall Benefits Case**

In summary, we agree with Ofgem that the net consumer benefits of DN sales are likely to be very significant and consider Ofgem's analysis of £225 million in net consumer benefits to be reasonable. However, further benefits could be demonstrated by taking account of the comments made in relation to the benefits and the conservative nature of shipper cost estimates as outlined above.

We accept that Ofgem's estimate reflects NGT's intended sale scenario (i.e. leading to the creation of three new independently owned comparators) and that benefits will be lower if less than three new comparators are created. However, based on the views we expressed above in relation to Ofgem's estimate of benefits and costs, we believe that actual net consumer benefits will remain significantly positive under any sale scenario, and remain to be convinced that a customer 'safety net' payment would be required to protect consumers' interests, even if only one new comparator were to emerge from the sale process.

**Roles and Responsibilities**

Through the workgroup process, NGT has underpinned its support for the “active” DN model favoured by Ofgem. NGT believes that this provides optimum accountability and, through clarity of roles, best ensures continuation of security of supply while also maximising the scope for efficiency savings and comparative regulation. We also believe that retaining the residual gas balancing role with NGT, as owner of the NTS, will ensure that the wholesale gas market is unaffected by the sales.

**Agency and Governance Arrangements**

We continue to support the Agency proposal and believe that, consistent with the input provided throughout the workgroup discussions, the Agency proposal will go a long way towards mitigating shipper costs resulting form the sales and therefore best protects the interests of gas consumers.

DN sales has the potential to increase the number of interfaces faced by shippers and suppliers, which could result in fragmentation, duplication and divergence of the arrangements these parties would need to interface with. This would represent a detrimental step to the industry, resulting in increased costs and inefficiency relative to the current arrangements.

Consequently, we strongly support the Agency concept to provide a common interface between gas transporters and their customers, which we consider will be a key aspect of mitigating increased costs and avoiding fragmentation in the industry.

We also support the creation of a Governance Entity (Joint Office) to administer the UNC modification process and the coordination of the administration of charging methodology amendments on behalf of the GTs, consistent with our proposals at DISG. To this effect, Transco and the IDNs will jointly establish and fund a Joint Office (a non incorporated entity). We are currently developing detailed proposals on the governance, funding and responsibilities of the Joint Office, which will be set out in an agreement (the Joint Governance Arrangements Agreement). The business rules of this agreement will be shared with Ofgem through the industry workgroups in due course.

**Offtake and Interruptions Arrangements**

As a result of DN sales, we accept that robust commercial arrangements will need to be established at the previously internalised interface between the NTS and the DNs, i.e. the NTS/DN offtakes. Furthermore, to ensure equality in treatment of all users connected to the NTS, these arrangements should also apply between NTS and directly connected customers. This will serve to ensure that access to the NTS is provided to all network users in a manner that is not unduly discriminatory.

We therefore consider that the Offtake and Interruptions arrangements proposed by Ofgem in the FIA are appropriate to protect the interests of customers under a divested industry structure. Accordingly we are working with Ofgem and the industry with a view to implementing these arrangements as part of the sales process.

**Security of Supply**

We note that Ofgem have given careful consideration to security of supply throughout the development of policy associated with DN sales and we strongly support this approach.

In our view, the proposed commercial and regulatory framework that has been developed to support a divested industry structure combined with the commitment from the Gas Transporters will ensure that security of supply is maintained following DN sales.

**Business Separation**

We recognise that DN sales raises new regulatory objectives that must be secured and regulated effectively. These are :

- To mitigate the risk of undue discrimination by Gas Transmission in favour of Transco's RDNs and;
- To ensure that the appropriate quality of comparative information is obtained in order to deliver the benefits of DN sales to consumers.

Ofgem is rightly concerned to ensure that these issues are adequately addressed.

We continue to believe that legal separation is an ineffective and inefficient measure to deliver these objectives. We are committed to continue working actively with Ofgem in order to find the most appropriate and effective governance measures to deal with these issues in a way that does not introduce unnecessary inefficiencies, which would not be in the interests of consumers.

We believe we have been making good progress in developing our proposals in this respect and will provide a full account thereof as part of our formal Section 8AA response.

## INTRODUCTION

This document sets out NGT's detailed assessment of Ofgem's Final Impact Assessment.

It covers the following elements:

- Analysis of consumer benefits
- Analysis of industry costs
- Overall consumer benefits of DN sales
- Roles and Responsibilities
- Agency and governance arrangements
- Offtake and interruption arrangements
- Security of supply

The analysis and views contained in this paper build on our responses to earlier Ofgem RIAs and have been updated and fine tuned where appropriate.

## 1. ANALYSIS OF CONSUMER BENEFITS

We support Ofgem's methodology for estimating the consumer benefits of DN sales is robust and support its base case estimate of £325 million in gross consumer benefits.

Ofgem's consumer benefits estimate is focused on the potential for savings in the DNs' allowed operating costs resulting from comparative regulation, and the benefits of reform in the offtake and interruptions regime**.**

A more detailed discussion of our views on Ofgem's benefits assessment is presented below. The first part of this section deals with Ofgem's estimate of the benefits deriving from operating cost reductions, while the second part of this section identifies some additional elements that could be taken into account.

### 1.1. Operating cost reductions

Ofgem has provided a detailed description of the proposed methodology and assumptions for estimating consumer benefits resulting from comparative regulation. The focus in this respect has been on assessing the scope for reductions in the allowed controllable operating costs resulting from comparative regulation.

#### Methodology and discount rate

Ofgem has considered and applied two **methodologies** to quantify the likely benefits of comparative regulation: an exogenous approach and an endogenous approach. While the endogenous approach has the advantage of replicating more closely the dynamics of how allowable operating costs will be set in the context of comparative regulation (efficiency frontier, catch up rates, etc.) and enables assumptions to be made about the efficiency levels and performance of specific DNs, an exogenous approach is arguably less complex and more transparent in terms of the extent to which different assumptions drive results.

In order to appreciate the impact of different approaches, NGT has developed models to estimate consumer benefits using both approaches and considers that both approaches are valid and produce broadly similar outcomes. These outcomes are in line with Ofgem's findings when using Ofgem's input assumptions. In the remainder of this response we have therefore for ease of reference focused on the assumptions used for the exogenous approach, which is the one favoured by Ofgem.

We have some reservations about the **discount rate** used by Ofgem to calculate the present value of operating cost reductions in the sale and no sale option. As the model results are very sensitive to the discount rate used, Ofgem's estimate may understate the present value of benefits to consumers. Ofgem uses a 6.25% discount rate, corresponding to Transco's assumed current real pre-tax cost of capital, to calculate a base case benefit to consumers of £325m. However, since it is the benefit to consumers that is being estimated, we consider that it may be more appropriate to adopt a discount rate aligned to the cost of capital of the average consumer. If we used the social discount rate (3.5% as per HM Treasury guidelines) as a proxy for the cost of capital of a typical consumer, the model would give gross benefits of over £457m.

**No sale option**

In order to appreciate the scope for future reduction of Transco's allowable controllable operating costs in the absence of DN sales, it is worthwhile considering that the rate of reduction of these costs has been declining in the past, with Transco's allowed controllable operating costs reducing at an annual rate of 2.5% in the current price control period, down from an annual rate of 3.8% in the previous price control period.

In line with Ofgem and most industry participants, we consider that the introduction of separate DN price controls in itself is likely to have a very limited impact on gas distribution operating costs.

On this basis we believe that Ofgem's assumption of a 3% ongoing reduction in Transco's allowed controllable operating costs in the future may overstate the operating cost reduction that might be achieved in the no-sale scenario (as it assumes an increase in Transco's operating cost reduction from the current price control period).

**Impact of comparative regulation**

Ofgem's principal objective is to protect the interest of consumers, where appropriate by promoting effective competition. In the case of distribution companies that are network monopolies, the promotion of effective competition can be supported through fostering the natural rivalry that exists between them and making effective use of comparisons between these companies in setting price controls. The value of comparators within the framework of yardstick regulation has been a notable feature of the electricity and water industries following privatisation. In gas too, customers should expect to benefit in perpetuity from cost savings generated by competing management teams who face efficiency comparisons at successive price reviews.

We therefore agree with Ofgem that comparative regulation will drive down allowed controllable operating costs in the DNs at a faster rate than if all DNs stayed in common ownership, because (i) it will give all DNs, both sold and retained, greater incentives to achieve efficiency savings, and (ii) it will improve data transparency and reliability, giving Ofgem greater ability and confidence to pass on those efficiency savings to consumers by setting more challenging targets.

Following a detailed review, we broadly support Ofgem's assumptions on the impact of comparative regulation:

- **Impact of number of comparators**: we agree that the benefits for consumers will vary in accordance with the number of additional comparators generated by DN sales: as the number of independent comparators increases, we would expect Ofgem to have greater confidence in the comparative data, thereby increasing the incentives on DNs to improve their efficiency; this is also consistent with views expressed by Ofwat and the Competition Commission, which have repeatedly stressed that the smaller the pool of comparators, the greater the value of each individual comparator.

- **Profile of improvement**: we agree that a bell shaped improvement curve is a more realistic assumption than a flat rate considering the relatively short duration between the completion of DN sales and the start of the next price control period. The actual assumptions made by Ofgem in this regard may be conservative as it can be expected that the new owners of the iDNs will generally be pushing hard to meet the promises made to their investors and analysts at the time the transaction was announced.

- **Differential in opex reduction between sale and no sale option:** Ofgem has assumed an average annual (base case) rate of allowed operating cost reduction of 4.1% across the next three price control periods as a result of DN sales, compared to 3% if all DNs stay in common ownership. We believe that a 1.1% differential resulting from comparative regulation is reasonable, as it is consistent with the difference in improvement rates between the electricity DNOs and NGC over the period 1991/2 to 2001/2, and the approach adopted by Ofgem to value the loss of comparators in the electricity distribution sector (Ofgem's May 2002 Policy Statement : "Mergers in the electricity distribution sector").

- **Impact of DN sales on economies of scale and scope**: The fact that potential DN buyers are willing to pay an average 14% premium to RAV for March 2005 suggests that those buyers see significant scope for merger synergies, allowing them to out-perform the regulatory targets across a combination of operating costs, capital expenditure and cost of capital. We recognise however that it is difficult to estimate the precise impact of DN sales on the economies of scale or scope of individual DNs and the industry as a whole.

  What in our view is certain, is that comparative competition will provide a strong incentive for DN management teams to introduce innovation and strive towards the most efficient operating model in order to outperform their peers. They will thereby continue to push the frontiers of financial performance, with customers ultimately benefiting from reduced prices.

### 1.2. Other sources of consumer benefits

DN sales can also be expected to create benefits for consumers in other areas, including efficiencies in capital and replacement expenditure, improved performance and customer service and the benefits of reform in the offtake and interruptions regime.

#### Capital and replacement expenditure efficiencies

We agree with Ofgem that comparative regulation could create benefits for consumers by giving DNs greater incentives to increase efficiencies in capital and replacement expenditure.

The experience of the water industry suggests that the use of incentives in the context of comparative regulation can indeed help deliver efficiency savings in capital and replacement expenditure[2].

**Improved performance and customer service**
The experience of comparative regulation in other regulated industries, both in the UK and beyond, suggests that it can also be an effective tool for encouraging companies to offer greater choice to customers and to drive improvements in performance and customer service.

For example, based on a composite scale of improvements in system reliability and availability, we estimate that the electricity DNOs have improved their quality of service by 20% over the last 10 years – despite a decreasing operating cost base. In the UK water sector quality of service has rapidly improved with measures such as unplanned interruptions, number of sewer floodings and properties at risk of low pressure declining by as much as 80% over the last 8 years. In the case of the water sector there has been heavy capital investment and consequential consumer bill increases, but comparative regulation has enabled the regulator to drive improvements through well considered incentive mechanisms.

**Benefits of offtake and interruptions reform**
We consider that Ofgem's proposals for reform in this area are helpful and will deliver benefits to consumers (compared to the no sale option) in a number of areas:

- more accurate investment signals leading to more efficient investment and operation of NTS capability,
- more efficient investment and operation of DNs resulting from:
    - the ability to trade off internal network capability and operational costs in the context of NTS exit product purchases
    - more efficient operational decisions in calling for demand management services
- removal of distortions that dilute market incentives to resolve supply / demand imbalances, therefore removing an efficiency of the wholesale gas market

Our detailed comments on the benefits of these reforms are provided elsewhere in this response. We recognise that these benefits have already been included in Ofgem's benefits assessment (£17m).

[2] *At the most recent price review of WaSCs, Ofwat used comparisons of relative capital maintenance and enhancement efficiency based on capital maintenance econometric models and comparisons of capital unit costs to determine catch-up improvements in capital maintenance and enhancement efficiencies for the water service.*

## 2. ANALYSIS OF INDUSTRY COSTS

This section addresses Ofgem's assessment of the costs that might be imposed on the industry as a result of DN sales, considering these in light of Ofgem's proposals on Roles and Responsibilities, Agency and Governance, and the Offtake and Interruption Reforms.

In assessing these costs, we consider the use of a pro forma shipper survey to be appropriate. In terms of the methodology used by Ofgem, we also consider the use of cluster analysis to remove outliers, and the Method B extrapolation to account for shippers not responding to the survey (by using costs associated with the second lowest set of shipper costs) to be appropriate.

### 2.1. Roles and Responsibilities

We share the view expressed by Ofgem that the decision on allocation of roles and responsibilities will not have a material impact on shippers. Individual networks will be responsible for planning, developing, maintaining and operating their networks, largely replicating the current arrangements within Transco.

### 2.2. Agency & Governance

We consider that the Agency concept, providing a common interface for a range of services provided by transporters to shippers, will mitigate against many of the costs shippers would otherwise face as a result of the sales.

#### Up-front costs

We broadly agree with the FIA assessment of up-front costs likely to be faced by shippers, given that the shipper survey (after removal of outliers) yielded a result not dissimilar to NGT's own assessment of costs in December 2003 (£14m).

#### Ongoing costs

We would challenge the assertion that there will be any significant recurrent costs for shippers. Although DN sales will cause shippers to see an increase in the number of formal, legal relationships with gas transporters, the real cost driver – the number and complexity of operational interactions – will remain largely unchanged. The establishment of a national Agency will ensure that the single Transco Shipper Services interface currently enjoyed by Shippers for many of these operational interactions will endure after DN sales.

In order to appreciate the impact of DN sales on key shipper processes, we have produced below a table, which for each key shipper process sets out how the process happens today, and whether/how it will change as a result of DN sales. The table below illustrates that DN sales will leave most Agency related processes unchanged and should therefore not lead to material incremental ongoing costs for shippers.

| Shipper process | Today – Provided by Transco | Post DN Sales - Provided by xoserve |
|---|---|---|
| Annual Quantity Review (AQ) | • Transco provides AQ across all DNs;<br>• Shippers provide Transco details of consumption that affect AQ | • No change<br>• Process managed by Agency<br>• AQ review is done per supply point, not per DN owner |
| Validation and processing of transportation invoices | • Transco issues invoices to shippers (approximately 30 invoices per shipper across different charge types)<br>• Invoices do not make distinction between different DNs | • Limited change<br>• Invoicing process managed by Agency<br>• Scale of system and process changes for shippers will be minimised; no meaningful increase in shipper validation and processing effort/cost expected:<br>    o Agency will produce an integrated 'thick' file to permit the current load/validation processes to continue; this would be supplemented by DN-specific 'thin' invoices<br>    o Validation effort linked to number of charge items, which is linked to number of supply points, which are unaltered<br>• NGT system change expected to cost £0.5m; shipper costs should be lower since their systems are less complex<br>• Shippers will need to make multiple BACS payments – limited cost (~£1000 p.a. per shipper) |
| Transportation charges validation | • Shippers validate transportation charges in Transco invoices<br>• Transportation charges will start to differ by DN as a result of the introduction of separate price controls (not DN sales) | • No change<br>• Invoices issued by Agency |
| Network charging methodology changes | • Changes to network charging methodologies currently managed by Transco as per Network Code mod process | • Change process will be co-ordinated by Joint Office on behalf of the GTs as per UNC mod process<br>• Highly unlikely to see diversity on charging methodologies:<br>    o Ofgem can veto changes that cause diversity that do not benefit customers<br>    o Co-ordination likely to result in methodology changes applying across all DNs if beneficial to consumers |
| Supply point transfer | • Shippers generate batch file to Transco requesting transfer of supply points<br>• Process managed by Transco | • No change to shippers<br>• Process managed by Agency<br>• Same file interface will continue to be used |
| Nominations | • Transco provides NDM (Non Daily Metered) forecast<br>• Shippers provide DM (Daily Metered) forecast to AT link | • No change – Agency to provide NDM forecasts<br>• Process managed by Agency<br>• Same forecasting methodology<br>• Shippers continue to provide DM forecast to Agency through AT Link |
| NTS/DN balancing charging | • Separate balancing and cash-out for NTS and each DN | • No change<br>• Process managed by Agency |

| Shipper process | Today – Provided by Transco | Post DN Sales - Provided by xoserve |
|---|---|---|
| Balancing settlement | • Transco issues and collects balancing invoice (neutrality principle across shippers) | • No change<br>• Agency will issue and collect balancing invoice from shippers on behalf of NTS |
| Letters of credit provision | • Shippers issue one letter of credit to Transco against all their liabilities for energy and transportation charges | • Shippers need to issue multiple letters of credit to Transco and IDNs, but the aggregate amount of credit will remain the same<br>• Fees are typically a function of the credit amount – so no material cost increase expected for shippers |
| Query management (I&C, Domestic) | • Queries managed by Transco | • No change<br>• Process managed by Agency<br>• Process stays the same - no changes to quality or query workload is expected |

We note furthermore that a number of respondents estimated an escalation of ongoing costs in relation to invoice validation on the assumption not only that the number of invoices would increase but also that the validation per invoice would increase, rather than assume the number of invoices staying the same (because of the introduction of Agency) and the more likely tapering down of costs as new systems and processes bed in. We note that Ofgem did not make any downward adjustment to account for this likely effect.

### 2.3. Offtake and Interruptions Reform

At the time of the Ofgem shipper survey, the new Exit and Interruption regime had not been specified to the level of detail that is now emerging. We therefore assume that shippers, in responding to the survey, have made understandably conservative estimates in the level of incremental costs (both one-off and recurrent) they will face.

We now have a greater level of specificity in definition of the future regime: the business rules for the new exit and interruption regime make clear that the primary impact will be on DNs, who will make arrangements for capacity booking, gas flows, etc, at NTS/DN offtakes by purchasing NTS exit capacity products. We believe these arrangements will have a positive impact, because DNs will have greater incentives to book appropriate NTS/DN capability, thereby leading to greater efficiencies and more cost reflective DN pricing to shippers that should be reflected in end-consumer prices. Consequently, we do not consider that these reforms will materially impact on costs for shippers, but rather will yield benefits to their customers.

We do acknowledge that shippers to NTS direct connected loads will be affected since a key design criterion of the new regime is to ensure equitability as between NTS direct connects and DNs at NTS/DN offtakes. Relevant parties (shippers at direct connects, DNs in respect of the NTS/DN interface) will have the opportunity to book exit capacity products and enter into demand management contracts over the long-term consistent with their needs. We expect the majority of direct connect shippers would adopt this long-term booking approach rather than engage in ongoing medium and short term bookings and trading to refine their holdings, unless they see a benefit in doing so. Accordingly, once these bookings have been established, ongoing interaction with the new arrangements for the majority of direct connect shippers is likely to be limited to ensuring their activities remain consistent with their holdings and to validating their associated charges. We do not consider that this will result in a material increase in ongoing costs for direct connect shippers.

We also acknowledge that some shippers may be faced with additional credit costs in relation to making long-term financial commitments for capacity products, though we would expect these costs to be modest as the credit processes would only relate to the bookings for a prospective 12 month period.

### 2.4. Other Cost Drivers

**Number of interfaces**
We note that shipper costs were developed on the basis of NGT selling four DNs, thus creating four new interfaces. However, since two DNs will be sold to a single buyer, and this buyer is likely to adopt a common approach in a number of areas across these two DNs, the number of interfaces created by DN sales will in effect only be three. This is likely to mean that certain costs identified by shippers in dealing with multiple interfaces have been overstated.

We recognise that shippers and suppliers may be concerned about the fact that a number of processes are not planned to be included in Agency (metering, connections and site works). We are explaining below why we would not expect shippers/suppliers to incur material costs in these areas.

**Metering**
We believe it is possible that due to the uncertainty relating to the regime change, some shippers may have counted costs that are more properly associated with the RGMA programme. Following the establishment of the new RGMA processes and data flows, most suppliers are already interacting with multiple meter providers and we believe that the industry is fairly well prepared for changes in the number of meter service providers as well as differing meter provision arrangements.

With the introduction of competition in the metering market, suppliers will have the commercial freedom to retain their current meter provider, seek meter provision from the competitive metering market or use the GT as a service of last resort provider. Suppliers are therefore not obliged to use the service of last resort (SOLR) offered by the GTs.

During an interim period of 12 months after the completion of DN sales, Transco Metering Services will continue to provide a last resort meter installation service on behalf of the iDNs under a managed service agreement in order to minimise change to supplier systems and processes. This will also give suppliers additional time to consider how to source their metering provision.

We recognise that at the expiry of the managed service agreement, suppliers will need to introduce some changes to their systems and processes to accommodate the iDNs as a meter service provider of last resort. However we would not expect the scale of those changes and the impact on one-off and ongoing supplier costs to be significant:

- Based on current meter provider arrangements and workload volume forecasts, Transco expects the number of SOLR meters to be quite minimal in the future (not more than 500 to 1000 SOLR meter installations per iDN per year), as most suppliers are likely to either retain their current meter provider or seek provision from the competitive metering market. As a result we find it hard to believe that suppliers would want to incur material one-off or ongoing costs in order to accommodate such a low volume of meter installations;
- Most of the work involved in accommodating the IDN as SOLR provider will be of a one-off nature; we would expect limited ongoing costs as the number and

complexity of transactions will not change as a result of DN sales: it is mainly the number of service providers that changes;

In terms of the RGMA baseline, we note that shippers/suppliers included costs to deal with different interpretations DNs might make of the RGMA baseline and any subsequent problems that might arise as a result of increased diversity in the SOLR processes. We consider this unlikely to occur as the work is already underway to resolve variations that currently exist, and the RGMA baseline is being refined under the governance of the SPAA to ensure that varying assumptions adopted by DNs and other meter operators become unlikely. Furthermore we would not expect the meter service providers to advocate too much change in the SOLR processes in view of the limited number of meters concerned.

Whilst we don't consider that the impact of DN sales on SOLR processes and costs should be material for suppliers, we are nevertheless committed to actively engage with suppliers on these issues in order to minimise any detrimental impacts to them.

**Connections**
Fulcrum Connections will continue to facilitate a single interface to shippers on behalf of the iDNs via a managed service agreement for an interim period. Whilst we accept that iDNs are likely to provide their own service in the longer term, it is not clear why this should add any material ongoing costs for shippers. In fact, the competitive pressures created by the introduction of comparative regulation may be seen as only increasing the likelihood of innovative plays that improve the quality, and push down the cost, of services to customers in the provision of connections.

**Siteworks**
We would further agree that because siteworks are undertaken on a case by case basis, the creation of multiple DN interfaces is unlikely to result in a material increase in costs associated with this activity.

In all these areas, it is worth noting that it is not expected that the underlying number of transactions will change as a result of DN sales.

## 2.5. Conclusions

Whilst we consider the assessment of £14 million in up front costs to be reasonable and broadly consistent with our own estimates, we believe that £7.1 to 8.8 million in ongoing costs identified in the shipper surveys may have been overstated.

We note that shippers included contingency costs to deal with further uncertainty going forward, but we do not consider that such costs should be included in the base case assessment. We also note that Ofgem have not made any downward adjustments to the figures provided by shippers in the survey in respect of these issues, but believe that the issues identified above point to areas where costs may have been overstated.

In our view, uncertainty over how the new commercial and regulatory regime established to support the new industry structure will affect industry parties will understandably may have led these parties to be conservative in their estimates. We believe that ongoing incremental costs will not be significant, largely due to the development of the Agency concept to maintain a common interface to shippers and suppliers. In our view, the present value of costs to the industry associated with DN sales will be somewhat lower than the conservative £101.4m figure presented in the FIA.

## 3. NET CONSUMER BENEFITS

Based on the above, we agree with Ofgem that the net consumer benefits of DN sales are likely to be very significant and consider Ofgem's analysis of £225 million in net consumer benefits to be reasonable. However, further benefits could be demonstrated by taking account of the comments made in respect of the benefits case and the conservative nature of shipper cost estimates as described in sections 1 and 2 above.

We accept that Ofgem's estimate reflects NGT's intended sale scenario (i.e. leading to the creation of three new independently owned comparators) and that benefits will be lower if less than three new comparators are created. However, we are convinced that actual consumer benefits will remain significantly positive under any sale scenario, and accordingly remain to be convinced that a customer 'safety net' payment would be required to protect consumers' interests, even if only one new comparator were to emerge from the sale process. We note in this respect that Ofgem's current calculation of the safety net payment is based on a low case scenario (i.e. low estimate for benefits, high estimate for costs) rather than the base case scenario.

## 4. ROLES AND RESPONSIBILITIES

Throughout the workgroup process, NGT has consistently supported the "active" DN model (Option 1). We believe that this provides optimum accountability and clarity of the roles and responsibilities of the NTS and the DNs, and as such best ensures that each transporter can meet its statutory obligations, that security of supply is maintained while also maximising the scope for efficiency savings through comparative competition.

Under Option 1, each DN will be responsible for all of the activities that take place within a DN; operation and congestion management, investment planning and investment, and DN maintenance planning and DN maintenance. This accountability is important to ensure that each network owner has certainty and clear responsibility allocated to him. This ensures that essential decisions regarding planning, investment and system operations are capable of being taken on a timely basis by each network owner. Without this certainty, the risks of failure, less efficient decisions and additional compliance costs would increase.

Placing accountability on the DN for operations and investment also creates the right incentives on the DN, who is best placed to make the most efficient trade offs between investment and use of diurnal storage and use of other system management measures, and we note the research conclusions that this model is used in the vast majority of systems around the world.

Furthermore, retaining responsibility for balancing gas demand and supply within the NTS will also help to avoid a fragmentation of the current wholesale gas market arrangements, preserving the NBP and ensuring continuation of security of supply.

It is proposed that regulated offtake arrangements would be established to define and govern the operational and commercial relationship between the NTS and each DN. Our comments on the proposed offtake arrangements are discussed elsewhere in this document.

# 5. AGENCY AND GOVERNANCE ARRANGEMENTS

## 5.1. Agency

We welcome the industry and Ofgem support for the Agency proposal and continue to believe that, consistent with the input provided throughout the workgroup discussions, the Agency proposal best protects the interests of gas consumers by promoting efficiency and economy on the part of licence holders.

DN sales has the potential to increase the number of interfaces faced by shippers and suppliers, which could result in fragmentation, duplication and divergence of the arrangements these parties would need to interface with. This would represent a detrimental step to the industry, resulting in increased costs and inefficiency relative to the current arrangements. The Agency will provide a **common interface** between gas transporters and their customers, which we consider will be a key aspect of avoiding fragmentation in the industry and minimising the level of change to existing systems and processes for the industry.

The Agency proposal will also ensure appropriate **accountability**. Fundamentally, this ensures that following the sale of one or more DNs, all gas transporters - that is the national transmission transporter ("NTS") and distribution ("DN") transporters continue to be responsible under the gas transporters' licence for the obligations contained in Transco's existing licence, with some additions in order to accommodate both new arrangements (such as Uniform Network Code) and the appropriate division of existing aggregated arrangements (i.e. conditions relating both to Transmission and Distribution). The role of the Agency is to act as subcontractor to each of the gas transporters; each DN and the NTS, enabling GTs to collectively discharge their obligations through a common interface.

For this function to work, the gas transporters must be able to collectively exercise **control** over the Agency. This is because the gas transporters will be dependent on the contractual undertakings of the Agent for fulfilment of their licence conditions. Therefore, joint representation of the gas transporters within the Agency through joint ownership and board representation is the most appropriate way to ensure that gas transporters can deliver their licence obligations. We have shared with the industry the Agency governance arrangements setting out ownership, control and accountability, together with the decision making structure. We believe these provide an effective means for enabling the Agency to act on behalf of all gas transporters, to the benefit of the industry.

The Agency governance structure, in combination with the stand-alone nature of the Agency, will bring with it greater **commercial focus**, creating the incentive to perform and improve customer service. New owners can also be expected to contribute new ideas about the way the Agency is operated.

We support the scope of the Agency services as defined in section 5.100 of Ofgem's FIA. At the same time we recognise the need to retain sufficient flexibility within these arrangements to allow the gas transporters to effectively support the long-term evolution and development of the industry. The scope of the Agency will need to be further refined in the future, and in the event that changes are necessary to relevant Licence and Code obligations, we recognise the need for these to be considered and consulted upon with the industry and with Ofgem.

Finally the Agency proposal will also facilitate the **competitive gas supply market** by providing a platform for the development of future industry initiatives to further develop competition in gas supply, such as the supply point administration and customer switching processes.

### 5.2. Governance arrangements

We also support the creation of a Governance Entity (Joint Office) to administer the UNC modification process and the process for introducing changes to network charging methodologies on behalf of the GTs, consistent with our proposals at DISG.

To this effect Transco and the IDNs will jointly establish and fund a Joint Office (a non incorporated entity).

We are currently developing detailed proposals on the governance, funding and responsibilities of the Joint Office, which will be set out in an agreement. The business rules of this agreement will be shared with Ofgem through the industry workgroups in due course.

Our comments on the licence modifications proposed by Ofgem in relation to the Agency and Governance arrangements will be issued as part of our formal license response.

## 6. OFFTAKE AND INTERRUPTIONS ARRANGEMENTS

DN sales will require robust commercial arrangements to be established at the previously internalised interface between the NTS and the DNs, i.e. the NTS/DN offtakes. Furthermore, to ensure equality in treatment of all users connected to the NTS, these arrangements should also be applied between NTS and directly connected customers. This will serve to ensure that access to the NTS is provided to all network users in a manner that is not unduly discriminatory. We consider that the proposed Offtake and Interruptions arrangements proposed by Ofgem as being appropriate to protect the interests of customers and under a divested industry structure.

The consultation process that Ofgem have followed to date has involved extensive interaction with the community to develop a set of workable offtake and interruptions arrangements. Our comments on the key features identified by Ofgem are as follows:

### 6.1. No undue discrimination

We agree that the arrangements must ensure no undue discrimination between users of the NTS, consistent with our licence obligations. Furthermore, given that we are proposing to sell four DNs and retain four, we accept that the regime must give other parties confidence that NGT does not have the potential to discriminate in favour of its own networks. The development of common products/services and common pricing for all users of the NTS, combined with greater transparency, will support this equality of treatment. We therefore support Ofgem's mitigation of the potential for undue discrimination through the design of the proposed commercial arrangements.

### 6.2. Offtake Arrangements under the Option 2A Model

We support the introduction of offtake arrangements under the Option 2A model described in the FIA. Under these arrangements, users will have equal access to a common set of exit capacity products under a common pricing regime. Furthermore, we agree that DNs should be liable for charges/overrun charges associated with these rights, with the associated costs passed to their customers subject to an incentive scheme. We agree that under this model, payment flows are relatively simple, minimising the number of payment interfaces between shippers and network owners. This model will provide a financial incentive on DNs to request efficient volume of rights consistent with meeting their 1 in 20 obligations, and provide efficient, financially backed investment signals to the NTS.

### 6.3. Unconstrained release of exit rights in the long run

We support the unconstrained release of firm exit capacity rights from three years ahead and beyond, consistent with investment lead-times. This will not only provide non-discriminatory access to the NTS, but will also provide long-term financially backed investment signals to facilitate the efficient and economic development of the NTS. Efficient investment will be further facilitated by incentivising the NTS to trade off investment in new capacity against the cost of buying back capacity in the long-term though demand management contracts.

### 6.4. Constrained release of exit rights in the short run.

In the medium and shorter-term, where it is not possible to invest in new capacity, we support the concept of a constrained release of any firm exit capacity that is not sold in the longer-term release process. Where demand exceeds supply in the constrained period an appropriate release mechanism would be required to ensure that unsold capacity is made available and allocated to users in a non-discriminatory manner. Where feasible and economic, NGT would look to facilitate the connection of new or increased loads as soon as possible through the use of demand management contracts to bring the firm demand within the capability of the NTS.

### 6.5. Spatial and Temporal Definition of Exit Rights

We welcome Ofgem support for a nodal model, as this will promote the efficient provision of additional capability by providing accurate locational signals for anticipated demand. NGT intend to augment this by introducing facilitated trading between nodes in the shorter-term to promote efficient utilisation of capacity within the system.

We also support the proposed release of annual bundles of daily exit capacity rights in the long and medium term, supported by the release of daily rights, where available, at the day ahead and within day stage. We agree that this will provide for a simple, more transparent release of capacity compared to a quarterly or monthly product, and provide investment signals regarding the peak level of demand users require in a year. Furthermore, the daily product will enable users who do not wish to use capacity at peak (for example storage operators) the opportunity to purchase daily interruptible capacity, as they require.

### 6.6. Diurnal Storage and Operational Flows

The FIA discusses the allocation of offtake flexibility available within the NTS. At present, DNs are allocated offtake flexibility consistent with meeting their 1 in 20 planning requirements. This is achieved by the NTS using inherent diurnal storage capability to satisfy the DN's flow flexibility requirement. For directly connected customers, offtake flexibility is effectively bundled with capacity, allowing users to adjust their offtake flow rates anywhere within their maximum capacity holding, subject to ramp rate, notice period/rate change limitations defined in their NexA agreements. Going forward, in order to ensure that the provision of offtake flexibility is provided to DNs and directly connected customers in a manner that is not unduly discriminatory, we recognise the merits and support the proposal for moving to a regime that creates a distinct commercial flexibility product as part of the sales process. As with capacity, we propose to augment this by introducing arrangements to allow trading of offtake flexibility between nodes in the shorter term.

Under these proposals, users will be able to purchase a flow flexibility product on an unconstrained basis (for greater than 3 years ahead) and on a constrained basis in the short and medium term, consistent with the primary exit capacity product. As with the primary product, it is proposed that this product is offered on a nodal basis in annual bundles of daily flexibility rights in the long to medium term, and that daily rights are also made available at the day ahead and within day stage to the extent that they are available.

The proposed flexibility product is defined as the excess cumulative volume of gas quantity offtaken during the period 06:00 to 22:00 compared with two thirds of the actual daily quantity offtaken. We believe that this product definition most closely aligns to the cost of providing within day flexibility and therefore is the most appropriate means of defining a distinct flexibility product. The alternative option of retaining the flexibility product bundled within the NTS capacity product would, in our view, give rise to significant additional costs for operating the NTS, which would ultimately fall on customers.

The commercial flexibility product will enable DNs and directly connected customers to signal the value they place on offtake flexibility, thus providing efficient, financially backed investment signals to the NTS for the provision of this product. DNs will then be able to trade off the costs of purchasing flexibility rights from the NTS with investment in storage in their own networks.

By revealing the commercial value that participants attach to offtake flexibility, the proposed regime will also serve to promote the development of any alternative means of storage where this proves to be economic.

### 6.7. Interruptions

We support the proposed reforms to the current arrangements for interruption, whereby the NTS will offer firm exit capacity in the long-and medium term, with the NTS tendering for demand management contracts on market based terms for constraint management. This will enable users to signal the value they place on offering demand management services, and facilitate efficient investment in the NTS by allowing the NTS to trade off investment in new capacity against the cost of buying back capacity through these contracts. The reforms will also promote economic and efficient operation of the NTS by allowing the system operator to call off the most cost-effective contracts when managing constraints.

We also support the proposal to complement these arrangements by offering a day ahead interruptible product, which will provide users access to the system at a lower price than the cost of firm capacity. The NTS will retain the right to interrupt these customers whenever demand reduction is required.

### 6.8. Interim Arrangements

The proposed arrangements will be implemented such that users will be able to book firm exit capacity and offtake flexibility rights during the summer of 2005 effective from October 2008. The NTS will tender for demand management contracts consistent with these firm capacity rights becoming effective. These proposals will enable existing market participants the time to prepare for the enduring arrangements.

During the interim period, we propose that new and existing users will continue to purchase firm and interruptible capacity rights at regulated prices, and any additional capacity requested will be made available to the extent that it is economic and consistent with our statutory and licence obligations.

With regard to the manner in which charges are levied for NTS exit capacity at NTS/DN offtakes, we propose to retain the current arrangement in the interim period whereby rights are assigned to shippers who then pay for these rights at regulated prices. Our preference for this option based on minimising the number of changes to industry processes, documentation and billing systems required for the interim period.

### 6.9. Continued Development Process

As described in the FIA, we are now further developing the exit regime proposals though the Exit Regime Forum (ERF). We welcome the community's engagement which is key to the successful implementation of DN sales. ERF has provided the opportunity to explain, clarify and receive feedback from interested members of the community about the proposals to deliver the policy objectives defined in the FIA. Our objective is to test the proposed business rules, thus informing the forthcoming NGT consultation on the new arrangements.

### 6.10. Economic and Efficient Decision Making

The FIA considers that separate ownership of networks following the sales might fragment decision making, giving rise to increased costs and inefficiency across the entirety of the national network. For example, a DN may take a decision to invest in its network when an investment in the NTS would have been more economic. However, we believe that the proposed offtake arrangements will mitigate against such fragmentation by allowing DNs to trade off investments on its own networks against purchasing capacity and flexibility rights from the NTS. In our view, the financial commitments required under the proposals are likely to bring greater commercial focus to the respective decisions made by the NTS and DNs, therefore enhancing the economic and efficient development and operation of these networks.

### 6.11. Governance of Offtake Arrangements

We support the proposal to include the new commercial arrangements within the UNC, consistent with all other commercial arrangements regarding the introduction, conveyance and offtake of gas. This will ensure common access to all users of the NTS (DNs and shippers of directly connected customers). We also support the proposal to include the more technical operator to operator arrangements in an ancillary document, which we currently refer to as the NTS/DN Operator

Arrangements, and which will be based on common terms and a change control process that will mirror the UNC. The NTS/DN Operator Arrangements will form the basis of bilateral contracts between NTS and DNs, analogous to NEXAs.

### 6.12. Conclusions

We support the proposed offtake and interruptions reforms described in the FIA as appropriate to ensure the interests of customers are protected under a divested industry structure.

## 7. SECURITY OF SUPPLY

We note that Ofgem have given careful consideration to security of supply throughout the development of policy associated with DN sales. We strongly support this approach and have recently issued a paper expressing our view that the proposed regulatory and commercial framework is consistent with the maintenance of security of supply following DN sales. Key aspects of the proposed framework relating to security of supply are described below.

- Under the roles and responsibilities proposals, the NTS will retain the national gas balancing role, thus ensuring that DN sales does not impact on the physical balance of supply and demand requirements for security of supply.

- Also under these proposals, each DN and the NTS will be responsible and accountable for the planning, development, maintenance and operation of its own respective network, consistent with meeting their 1 in 20 obligations. We believe that this will serve to maintain current levels of pipeline security.

- Under the offtake proposals, each DN will be able to secure the necessary NTS exit capacity and flexibility rights to meet its 1 in 20 obligations. These arrangements will ensure that such rights are provided on an equitable basis to all users of the NTS, thus mitigating concerns that retained DNs might be favoured over the sold DNs in the allocation of such rights, to the potential detriment of security of supply in those networks

- The proposed reforms of the offtake arrangements will provide clarity of roles and responsibilities in relation to the interface between the NTS and DNs. We consider that the clarity in this respect provided by the offtake arrangements is a key requirement for pipeline security to be maintained across the NTS/DN interface.

- The proposed offtake arrangements will also provide financially backed long term investment signals to the NTS for the provision of exit capacity and offtake flexibility, which will assist the NTS in developing a secure and efficient network going forward

- Access to demand management (interruption) is key to maintaining pipleline security. Under the proposed reforms interruption will continue to be accessible to the NTS via demand management contracts. The introduction of commercial elements to this service is likely to encourage more users to offer demand management services to the NTS, thus benefiting security of supply.

- The current arrangements allow NGT to call interruption in the event that demand exceeds 85% of peak, but these actions do not feed into cash out prices. This has the potential to dilute incentives on the market to resolve supply/demand imbalances. Reforms to the interruptions arrangements will remove this distortion, thus providing stronger incentives on the market to respond to supply shortages, ultimately benefiting this aspect of security of supply.