

TOTAL GAS & POWER LIMITED

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Dear Sonia,

Consultation Response – National Grid Transco – Potential sale of gas distribution network businesses – Final Impact Assessment November 2004

Total Gas & Power Limited are writing in response to the request for views invited on the above document. We have included as part of this response a summary of our views which is supported by a more detailed breakdown of areas related to the sale where we have either serious concerns or where we believe more work needs to be done before a final decision by the Authority, on whether or not the sale should be allowed to proceed, can be taken.

Response Summary

The sale of one or more Distribution Networks represents the biggest reform to the UK gas industry since it was privatised. It is also a change that would be practically impossible to reverse. It is therefore critical that any analysis carried out to evaluate the sale be both quantitative and qualitative. By this we mean that in addition to looking at theoretical benefits, mainly derived from comparison with other industries, proper account should also be taken of the views and concerns of those who have practical experience of the industry.

We believe that, unless the sale can demonstrate both short to medium term benefits to end consumers and absolute confidence that it will continue to provide long term benefits over and above those that could be gained from incremental refinement of the existing industry structure, the sale should not be allowed to proceed.

At this time we have the following major concerns that we believe require further work to be done before a final decision can be taken by the Authority. These concerns are expanded on later in the detailed response.

- Is there sufficient confidence that the medium and long term consumer benefits as presented in the RIA will be in practice be achievable and further that they will only be achievable through the DN sale proposal as opposed to incremental reform?
 - Whether reforms to Exit, Interruption and Flexibility are absolutely required as a condition of the sale, particularly when it is noted that they will account for much of the cost whilst delivering very low benefit (less than 5%)?
 - Whether a sale will frustrate the development of competition within shipping, NBP/OCM trading and supply?
 - Whether the new industry structure will be capable of delivering the same or an improved level of confidence in safety and security of supply of the UK gas network as is delivered by the current structure?

- Whether the pressure to deliver an early decision has meant that important processes have been inappropriately rushed and that potentially sensible alternatives have been excluded from proper evaluation?
 - If the sale benefits are so clear, why haven't the major end consumer groups been more vocal in their support?

Detailed response

Is there sufficient confidence that the medium and long term consumer benefits as presented in the RIA will be in practice be achievable and further that they will only be achievable through the DN sale proposal as opposed to incremental reform?


TGP would be supportive of a sale if it could be demonstrated to produce tangible overall short to medium term benefits for end consumers as well as delivering the optimum structure to maximise long term benefits. There must however be no room for any doubt when making the decision because of the fundamental changes involved as there will be no realistic way of backing out a sale once it has taken place. Alongside this the sale process itself needs to be conducted in an appropriate manner to minimise the resultant industry disruption.

It is essential that the benefits from comparative regulation presented for the DN sale only include those that can be obtained via a sale as distinct from those that can be gained through continuing regulation of the current no sale regime including those obtainable from separate DN price controls. The 2002 reports¹ promoting separate price controls made significant play of the opportunities for comparing the performance of regional networks and thus enabling more effective regulation and promoting savings. We are surprised that the RIA is now reasonably dismissive of the potential for future cost savings for this.

We believe that the way NGT have structured the sale will make comparative regulation more difficult:

- The different geographies and population densities between the retained networks and the independent networks will hamper the establishment of valid comparators. Furthermore, by keeping the 4 central DN's, which have the highest population concentration and thus greatest number of connections per km of pipe, the IDN's will find it very difficult to individually compete with the RDN's. Thus NGT will have significant incentive and ability to ensure that their future allowed revenue is protected by not appearing to be unduly efficient in comparison to the new independently owned DN's being run by new innovative management. This is accepted by Ofgem in their argument against separate price controls²
- 2002 documents re separate Price Controls showed that the biggest potential for reduction in distribution charges was across the 4 retained regions – 16% in the RDN's versus 10.4% in the IDN's over the period 2002 to 2016 and 13.6% versus 7.9% over the period 2016 to 2027³. NGT will have very strong incentives to make sure that information on efficiencies across the retained DN's is presented in such a way as to minimise their exposure and continue to maximise their allowed price control revenue
- Ofgem have backed down on legal separation which will make it even more difficult to identify potential efficiencies within the NGT retained network

Additionally because any sale will be practically irreversible, there is a potential for loss of future benefits and incorrectly claimed sale benefits:

 ¹ Ofgem July 2002, Separation of Transco's distribution price control: Initial Consultation Document and December 2002, Separation of Transco's distribution price control: Draft Proposals
² Ofgem Final Impact Assessment – paragraph 8.38 (page 112)
³ Separation of Transco's Distribution Price Control – December 2002 Table 5.3

- It is likely that future improvements that could have been introduced under a fully integrated, single owner network, will no longer be possible once one or more of the DN's have been sold. NGT have recently announced significant progress in the development of their centralised Operations and Distribution Support for the DN's they will retain with an aim to achieve a 35% real reduction in controllable costs over the five years to March 2007⁴. Presumably these economies of scale will not be available for the IDN's.
- The benefits associated with a sale over the 'no sale' option should only be counted if the sale is the only possible way that such benefits could be achieved. For example it is an incorrect assumption to suggest that only a sale will develop best practice. There is no reason why a single monopoly should not be able to do this, for example wide spread use of JV's with electricity/water companies to reduce overall maintenance costs. NGT already report that new Construction alliances are being developed to improve the cost-effectiveness and delivery of the mains replacement programme.⁵ The limiting factor is the ability of a regulator to recognise potential and provide the appropriate incentives.

Even where benefits can potentially be determined through comparator analysis, it will require strong regulatory intervention to identify and quantify these:

- Will Ofgem have the necessary skills to properly analyse the results of comparators and identify where tighter expense and investment targets could be set? Whilst it is stated that all the benefit assumptions are conservative they are still driven by the basic assumption that the same type of results that have been achieved in so called comparator industries (water and electricity) can be replicated in gas. We have strong concerns as to whether this is actually a reasonable assumption in that gas has come from the background of a single monopoly where over the past 15 years it has been subject to increasingly onerous expense reductions targets whereas the comparator industries have been a number of individual monopoly businesses that have only more recently been subject to tighter expense reduction targets. Additionally there are higher numbers of comparators in electricity and water.
- We also believe that Ofgem have been over optimistic in their assessment of the additional resource they will require to carry out full comparative regulation
- We would also question why such a long period has been used to calculate the NPV. Most of the costs associated with the sale will be incurred in the first year. Bearing in mind the degree of change within the industry over the last decade is it really valid to look at benefits over a 15 to 18 year period? We note that Ofgem accept that there will be little opportunity to capture benefits until the second price control period i.e. at least 8 years on from the time of sale

Costs

- We have no major issues on the work done re the costs of implementation of the sale. However we do believe that the industry may have underestimated the costs that will be incurred to set up and administer the proposed exit capacity arrangements as at the time of the provision of cost information, there was no real information on how extensive the required reforms would be. Also we continue to disagree with Ofgem's view on the costs of the new Credit arrangements. Our concern here is not the cost of establishing additional credit agreements but rather the belief that the overall credit cover that will be requested will be higher as a result of 5 or more credit agreements as opposed to a single agreement. We also believe there will be some periods during sale transition where we will need to overlap on credit cover.
- What is very clear is that a large proportion of the costs will be incurred as soon as the sale occurs and will continue for some time before the potential eventual benefits start to appear. This may mean that as result this increase in the retailing overhead, customers could face price increases initially, adding further pressure on retail gas prices.



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⁴ NETWORKING – NGT publication Issue 21 December/January 2005

⁵ NETWORKING – NGT publication Issue 21 December/January 2005

- We also have some concerns that the proposals being considered for Joint Office Governance will result in increased costs in this area. However we also believe that the way forward for this area is very unclear as there has been no formal consultation carried out on the proposed reforms.
- We are disappointed that Ofgem appear to have gone back on their support to limit changes to transportation charges to once a year only.

Whether reforms to Exit, Interruption and Flexibility are absolutely required as a condition of the sale, particularly when it is noted that they will account for much of the cost whilst delivering very low benefit (less than 5%)?

- We believe that the case has still not yet been properly made for the level of offtake reform that is being proposed by Ofgem. If this is a key area forming part of the Authority's decision criteria then the decision should be delayed as many of the details of the reforms are still undecided. If it is not a key area for a sale decision then it should be taken out of the RIA. Either way we believe that there is a need for a separate impact assessment covering this aspect of proposed reform
- The introduction of Exit Reform has been insisted upon as a Gateway issue with the justification being that without it there is the potential for discrimination between the NTS and the RDN's versus the IDN's/NTS connects. When it was argued that such discrimination could be handled via a licence condition, Ofgem rejected this argument without evaluating the savings in terms of eliminating the need for exit and flow flexibility reform. We are still uncertain as to why Ofgem are so insistent that a potential discrimination issue cannot be addressed through licence. If there is a concern one would assume that the pressure for a non licence solution would be coming principally from potential DN buyers but we are not aware that this is the case.
- Our preference is that Exit Reform should be de-coupled from the DN sale with the use of a licence condition(s) to counter the perceived discrimination potential. Existing arrangements should be allowed to continue with simple rule based mechanisms dealing with the NTS / DN interface. If necessary, further reform could then be implemented following any sale, once the full impact has been considered. In this way more appropriate and proportional solutions could be developed.
- On the assumption that a licence type solution is not suitable and that instead offtake and exit arrangements reform must be implemented, where does this leave the short term risk in the interim, bearing in mind that the full solution as proposed by Ofgem will not be able to be fully implemented for 3 years? Does this not infer that the full DN sale cannot go ahead until the reforms are fully implemented?
- We are intrigued as to why the implementation costs for NGT to achieve Legal Separation have been taken into account and then used to justify a decision against Legal Separation. In other areas Ofgem have rightly argued that any expense that NGT need to incur in order to make required changes to allow the sale to go ahead are costs that must be incurred by NGT outside of the ir regulated business. Either legal separation is required or it isn't and we are still unclear as to what has changed from the outset of the sale when Ofgem were insistent that it would be a requirement. We are also interested as to why licence conditions can now be justified instead of separation. This would appear to be contradictory to the approach being taken on exit.
- We would support the arguments against the Hive-down of the NTS but do not believe the arguments against the Hive-down of the RDN's (which is the area we believe was thought to

be necessary in order to allow some opportunity for comparative regulation) are as compelling.

Whether a sale will frustrate the development of competition within shipping, NBP/OCM trading and supply?

- Has any proper assessment been made re the potential for the DN sale to reduce competition between Shippers and Suppliers though increased complexity and regulatory uncertainty? The document notes that up to 3 small gas shipper/supplier businesses may be adversely affected by the costs of implementing the proposed framework of arrangements. However the success of the UK Gas Liberalisation to date has been the creation of meaningful and effective competition to ensure that cost savings as a result of efficiencies in all areas of the market are passed through to consumers. Any reduction in this, however small, could have far greater negative impacts on end consumer prices than the positive impact of potentially lower distribution costs envisaged by the sale. Further the scope for regulatory oversight is far greater in the licenced monopoly area than it is in the non monopoly area.
- No assessment appears to have been made of the potential for future changes as a result of the sale and the costs associated with these. In any major change to date – RGTA, Entry Auctions - it has been a number of years before the full impact has been recognized and the rate of change to correct/improve the regime has slowed down such that the initial expected benefits come close to being achieved. There is a significant industry cost associated with such change. The DN Sale is a similar change of equal if not greater magnitude. Has any assessment been made of either the cost and/or the risk of future changes required to make sure that the new regime works correctly?
- Until any reform is fully implemented and demonstrated to be working satisfactorily, there could be potential for the market participants to place a higher risk premia on the cost of doing business to account for increased uncertainties – capacity reform, flexibility etc.
- It is clearly stated in the document that 95% of benefits of a sale are believed to be created by the ability to carry out comparative regulation. We would again therefore make the point as to whether the changes required to produce the remaining 5% are in fact justifiable bearing in mind the degree of complexity associated with these changes.
- Whilst the requirement to purchase Flexibility is still being developed within the industry, it would seem clear that the approach being recommended by Ofgem is complex. The potential costs associated with the service are, as yet, unknown but if the mechanism is to have any impact then at some stage they must become significant. It therefore seems evident that not only will the operational risk increase for large NTS connects including CCGT's but in turn this is likely materialize in an increase to the associated risk premia and therefore put pressure on wholesale electricity prices.
- There is also a perception that the UK is continuing to add further complexity to the operation of the gas market contrary to the European objectives of harmonization of balancing regimes etc. This could be seen as detrimental by European players who are more comfortable with the relative simplicity of the rest of the European market? The impact of this could be that they would be more reluctant to trade in the UK which could have knock on effects on the availability of competing sources of gas.

Whether the new industry structure will be capable of delivering the same or an improved level of confidence in safety and security of supply of the UK gas network as is delivered by the current structure?



- There is a concern that whilst new management may be more innovative they may not have the same deep rooted commitment to a safe and robust gas network or the same level of understanding of custom and practice as the current NGT management, irrespective of the safety case requirements. This could give rise to both a security of supply concern and a safety impact if DN's decide to reduce/postpone investment, cut back on maintenance or introduce new ways of working. Whilst we accept that this argument could equally be applied to the current industry structure there is a belief that NGT's history and culture would ensure that they would be more reluctant to adopt new practices and procedures if there was any possibility that safety could be compromised. As such we would have expected to see some form of risk assessment of this in the RIA.
- We also note that the Gas Industry Safety Group has previously commented on some areas of concern such as future Governance of technical standards and Provision of Emergency Services. We are not yet convinced that the work to date has fully addressed all aspects related to Emergency Services Provision and metering issues. When the industry first deregulated there was concern that safety standards would suffer as responsibilities became diluted across a number of participants rather than focused in the hands of one. The DN sale raises similar concerns particularly when there will be very significant financial pressures to reduce costs and raise efficiency levels.
- Similarly separate DN managements with differing philosophies and incentives could result in different focus or importance placed on issues such as Data Quality. Whilst this is key to Shippers and Suppliers it is not a priority for the networks. Many industry participants already have serious concerns that initiatives such as RGMA are resulting in reductions in the quality of metering data. Obviously any reduction in quality is likely to put additional strain on areas such as the Customer Transfer process with the potential for a reduction in transfer numbers and a deteriorating shift in the gas performance towards that seen in electricity.

Whether the pressure to deliver an early decision has meant that important processes have been inappropriately rushed and that potentially sensible alternatives have been excluded from proper evaluation?

- We continue to have concerns over the process that is being followed to develop the Uniform Network Code. The proposed timetable would appear to give very little time to review both new business rules and associated legal text. The risk here is that the resultant Code will not be fully effective and the industry will then go through a large period of uncertainty and change whilst modifications are raised to improve the Code.
- The number of meetings and project documents is such that the majority of companies no longer have the resources to keep up with the process. This is aggravated by issues being spread across different documents such as the RIA and the Licensing: Next Steps. Whilst we accept that a project such as this cannot be run to accommodate every individual licensee, we do believe that the current plan (albeit very high level) needs to be reviewed to reflect the slippage that has occurred in a large number of areas.
- Some potential alternatives to accommodate the sale do not appear to have been given proper and full consideration in the workgroups that have been set up to consider solutions. For example an augmented planning methodology as an alternative to flow flexibility was dismissed before the industry could properly assess its suitability
- This is exacerbated by the concern over process about the way discussions are being held between NGT and Ofgem without the involvement of other parties including Shippers. Whilst we recognise that NGT is clearly incentivised to complete the sale in the shortest possible

timescale and at the least cost, our concern is that as Shippers we have no alternative transportation provider and normally, therefore, we would look to the Regulator to make sure that no elements of due process are bypassed and that all industry concerns are properly listened to and evaluated.

- An example of this concern would be the discussions held within the industry groups such as the DISG, chaired by Ofgem. It is clearly our belief that such groups cannot take decisions but can only discuss alternatives and inform attendees. However it is then necessary for the alternatives to be formally presented through the established consultation processes in order to ensure that everyone has an opportunity to best understand the implications and to comment as appropriate. Areas of specific concern with regard to how the process has been managed relate to the new Exit and Flexibility arrangements and the Joint Office proposals for governance.
- We also support the concerns of a number of industry participants over the approach that is being taken to change the transportation/distribution licence. We note that the Gas Forum has written to the Energy Minister, attaching a legal view which states that that the process being followed may not conform to the Gas Act. Overall it is felt that separate Transmission and Distribution licences would be more desirable and better reflective of the fundamental reform to the UK Gas Network that the DN Sale will engender.

If the sale benefits are so clear, why haven't the major end consumer groups been more vocal in their support?

- As a major supplier to the Industrial & Consumer market, we have seen no evidence that the consumer associations have been convinced of the benefits that a sale would be expected to deliver for themselves. Overall we find this rather disturbing. Whilst we recognise that players such as ourselves may feel that the sale is merely imposing change and cost with no resultant bottom line benefit, we would have expected that consumers and consumer representatives would have been lobbying very hard for the sale in order to deliver the supposed benefits at the earliest opportunity. If the customers themselves are not actively campaigning for the sale then why are Ofgem driving it through so aggressively?

Please contact me if you would like further information on the above.

Yours sincerely

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