

**National Grid Transco – Sale of gas
distribution networks**

Authority Decision

**Transco plc applications to dispose of four
gas distribution networks**

February 2005

Summary

This document sets out the decision of the Gas and Electricity Markets Authority (the Authority) on the four applications submitted by Transco plc (Transco), a wholly owned subsidiary of National Grid Transco plc (NGT), under Amended Standard Condition (ASC) 29 of its Gas Transporter's (GT) licence. These applications request consent from the Authority to the proposed disposal of four of Transco's gas distribution networks (DNs) to four wholly-owned subsidiary companies, the shares in which would subsequently be sold to third party purchasers.¹ These applications for consent were considered at a duly convened meeting of the Authority on 20 January 2005 and are attached in Appendix 1 to this document.

The Authority has provided its conditional consent to Transco under ASC 29 in the terms described in Transco's four applications for consent. The decision and the conditions to the consent form the subject of four Consent Directions which are attached as Appendix 2 to this document.²

The Authority's decision on Transco's applications for consent has been arrived at having had due regard to its statutory objective and duties and its public law duties. In addition, the Authority has taken into account the statutory and licence obligations of gas transporters.

The Authority's assessment of Transco's applications followed an extensive consultation process, undertaken by Ofgem since July 2003, regarding the proposed sale of gas distribution networks and its potential impacts upon customers.

The Authority's assessment of Transco's applications involved careful consideration of amongst other things (and without limitation):

- ◆ the Final Impact Assessment (Final IA) on potential DN sales which was published for consultation in November 2004³;
- ◆ the responses to the Final IA; and

¹ Transco also applied for consents under Paragraph 3 of Schedule 3 to the Gas Act 1986 (the Gas Act) to permit it to dispose of land (relating to the four relevant gas networks) that it has acquired compulsorily, to the four relevant wholly owned subsidiary companies. The Authority consented to these applications at its meeting on 20 January 2005.

² This document constitutes a notice of the Authority's reasons for its decision which it is required to set out under section 38A of the Gas Act 1986.

³ *National Grid Transco – Potential sale of gas distribution network businesses – Final Impact Assessment – November 2004.*

- ◆ direct representations which it has received (in response to consultations undertaken by Ofgem).

The Authority's response to the issues raised by respondents to the Final IA is set out in this document.

In granting its conditional consent to Transco, the Authority has concluded that the base case estimate, set out in Ofgem's Final IA, of the potential net benefits to customers of approximately £225m associated with the proposed DN sales transaction, is reasonable and robust. The Authority is also satisfied that the interests of customers in terms of competition and security of supply can be protected in the event of a sale. The Authority therefore accepts that the interests of customers would be protected in the event of the DN sales transaction proceeding.

The Authority considers that the separate ownership and management of DN businesses would enable Ofgem to compare and contrast DN performance through the price control review process undertaken by Ofgem. In this respect, the Authority agrees that there is significant evidence from the electricity and water industries that supports the benefits to customers of comparative network regulation.

The Authority has also endorsed its previous decisions on the proposed regulatory, commercial and operational arrangements necessary to protect the interests of customers in a divested industry structure. This includes the Authority's endorsement of the continued development of the enduring offtake arrangements for the allocation of National Transmission System (NTS) exit capacity and NTS offtake flexibility through the DN sales process. The Authority has concluded that all of the proposed enduring offtake arrangements are reasonable and proportionate and protect the interests of customers.

In view of the concerns expressed by respondents to Ofgem's Final IA regarding the timetable for the introduction of the proposed enduring offtake arrangements, the Authority has concluded that the implementation of the enduring NTS exit capacity and NTS offtake flexibility arrangements would not need to occur prior to the completion of the DN sales transaction.

However, whilst the Authority considers that a short delay in the implementation of the enduring offtake arrangements is appropriate, it does not consider that their introduction should be delayed beyond September 2005. The Authority considers that any delay to the introduction of the enduring offtake arrangements beyond September 2005 would

be against the interests of customers and would increase the potential for customers to incur costs as a result of inefficient investment or system operation decisions. As such, the Authority has concluded that in order to protect the interests of customers the enduring offtake arrangements should be implemented by September 2005. In order to achieve this, the Authority has imposed conditions to its consent on Transco and intends to propose a series of licence conditions on Transco and DNs to secure the implementation of these arrangements on a best endeavours basis. These are discussed below.

Other consents

It is noted that the proposed DN sales transaction is also subject to the consent of the Secretary of State under ASC 29. The Secretary of State granted this consent on 27 January 2005.

In addition, in order for DN sales to proceed, the Health and Safety Executive (HSE) will need to consider a revised Transco safety case for its NTS and retained DN businesses, as well as safety cases for the four wholly-owned subsidiary companies to which DN assets are to be hived down. The purchasers of the DN businesses also need to have their safety cases accepted by the HSE before they can take over the operation of these businesses.

Conditions to consent

The Authority has granted its consent to Transco at a time when the details of the regulatory, commercial and operational arrangements necessary to protect the interests of customers in a divested industry structure, are still being consulted upon and developed. It is therefore important for the Authority to ensure that it is satisfied that the arrangements that are to be developed and implemented over the coming months protect the interests of customers and are consistent with the Authority's objective and statutory duties. In order to achieve this, the Authority has decided to impose conditions to its consent relating to the development and implementation of these arrangements.

Prior to the consent becoming effective Transco will need to comply fully with the conditions to consent set out in the Authority's Consent Directions (attached as Appendix 2 to this document).

The conditions have been imposed over two phases. As part of the first phase there are conditions precedent which are required to be satisfied prior to the proposed hive down of DN assets to the four wholly-owned subsidiary companies. As part of the second phase there are conditions subsequent to the hive down. These conditions will need to be met before Transco can proceed with selling the shares in the four wholly owned subsidiary companies (which will at that stage own the DN businesses) to the third party purchasers.

Phase 1 conditions

In general terms the Phase 1 conditions provide that Transco is not permitted to hive down its DN assets into its four wholly owned subsidiary companies until:

- ◆ Transco has consented to the modifications to its six GT licences as part of the initial section 23 licence modification process to separate out Transco's price controls⁴, as well as the proposed section 8AA licence modifications (and related section 23 licence modifications in respect of Transco's NTS and retained DN businesses) necessary to protect the interests of customers in a divested industry structure and these modifications have become effective;
- ◆ The Authority has consented under section 8AA of the Gas Act to the transfer of the four GT licences relating to the proposed independent DN businesses from Transco to each of Transco's four wholly owned subsidiary companies respectively;
- ◆ The Authority is satisfied as to the proposed arrangements as part of DN sales for industry codes including (without limitation) the Uniform Network Code arrangements and has directed the implementation of Transco's proposed modification to its existing network code to create a short form network code that references the UNC;
- ◆ The Health and Safety Executive has accepted the safety cases of each of the four wholly owned subsidiary companies (and of Transco in respect of the NTS and the DNs it is proposing to retain) pursuant to the Gas Safety (Management) Regulations 1996;

⁴ *National Grid Transco – Potential sale of gas distribution network businesses, Licensing: Next Steps, Formal consultation under Section 23 and informal consultation under Section 8AA of the Gas Act 1986, Ofgem, November 2004.*

- ◆ The Secretary of State has consented to the proposed hive down of DN assets to each of the four wholly owned subsidiary companies under ASC 29 of Transco's GT licence. As noted above, the Secretary of State has now granted this consent;
- ◆ The Secretary of State has granted the proposed exemption under section 6A of the Gas Act to Transco's NTS business and the DNs in respect of the proposed offtake arrangements;
- ◆ All other consents, approvals et cetera relating to the hive down of the four DNs to the four wholly owned subsidiary companies have been unconditionally obtained;
- ◆ Transco has procured undertakings from NGT, and the proposed third party purchasers, that each respective party will refrain from actions that would be likely to cause Transco to breach any of its obligations under the consent or which would be likely to prevent Transco from taking appropriate steps to satisfy any conditions to consent and that each party will use its best endeavours to ensure that it implements the enduring offtake arrangements are implemented by 1 September 2005.

The Consent Directions specify that if any of the conditions are not satisfied by 1 May 2005 or if the Authority is of the opinion that any such condition is not likely to be satisfied by that date, then the Authority is entitled to extend the period for satisfying the conditions to an alternative date or waive or modify the conditions.

Phase Two conditions

The Phase Two conditions provide that Transco cannot sell the shares in its four relevant wholly owned subsidiary companies without the Authority's prior consent. In addition, the Phase 2 conditions provide that Transco shall consent to any licence modifications and implement any other regulatory, commercial or operational changes following hive down that the Authority considers are necessary in order to ensure that the interests of customers are protected.

The Authority considers that these conditions are necessary given that Ofgem intends to issue a section 23 notice in May 2005 to modify the NTS and DN licences to, amongst other things, introduce interim incentive arrangements following the scheduled hive-down date. It is also necessary for the Authority to retain control over the share sale given that other issues may arise through the development and implementation of the detailed regulatory, commercial and operational arrangements that have not yet been anticipated and addressed.

Implementation of the enduring offtake arrangements

In order to achieve the implementation of the enduring offtake arrangements by September 2005, the Authority has imposed certain conditions to its consent that must be met before Transco can be permitted to hive down its DN assets to its four relevant wholly-owned subsidiary companies, scheduled to occur on 1 May 2005.

For the period following hive down and share sale the Authority intends to propose a number of licence conditions on Transco and the DNs relating to the implementation of the enduring offtake arrangements.

Enduring offtake arrangements – conditions to consent

The first of the conditions to consent relating to the enduring offtake arrangements is that Transco must procure undertakings addressed to the Authority from NGT, specifying that NGT will, prior to the proposed section 8AA (and related section 23) licence modifications to the six Transco GT licences becoming effective, use its best endeavours to ensure steps are taken to ensure that the enduring offtake arrangements will be implemented by 1 September 2005.⁵

The second of these conditions is that Transco must procure undertakings addressed to the Authority from each proposed third party purchaser that prior to the completion of the sale of shares to the new purchaser, such purchaser will use its best endeavours to ensure that the relevant DN takes steps that are required in order to implement the enduring offtake arrangements by 1 September 2005.

Enduring offtake arrangements - proposed licence conditions

In order to cover the period following hive down and the subsequent sale of shares in the four wholly owned Transco subsidiary companies to the new purchasers, the Authority intends to propose a number of licence conditions on Transco and each DN regarding the implementation of the enduring offtake arrangements. Transco and the DNs will be required to accept these licence conditions before hive down can take place.

⁵ The enduring offtake arrangements are described in chapter 5 of Ofgem's Final IA.

In particular, the Authority intends to propose licence conditions, binding upon Transco and each of the DNs, requiring them to use their best endeavours to implement the enduring offtake arrangements by 1 September 2005.

The Authority also intends to propose, as part of the licence condition binding upon Transco, an obligation upon it to procure from NGT an undertaking to the Authority that it will use its best endeavours to ensure that that the enduring offtake arrangements will be implemented by 1 September 2005.

Further, the Authority intends to propose, as part of the licence condition binding upon each independent DN, an obligation requiring it to procure an undertaking addressed to the Authority from its ultimate controller that it will use its best endeavours to ensure that the independent DN implements the enduring offtake arrangements by 1 September 2005.

Ofgem proposes to consult upon these proposed licence conditions in February 2005 as part of the proposed Section 8AA and associated Section 23 licence modification proposals to Transco's existing GT licences.

In issuing this decision document it is important to make clear that that there can no expectation on the part of NGT, Transco, potential shippers, suppliers or any other interested parties as to any further decisions which the Authority may be required to take or any further consents which the Authority may be required to grant (including for the avoidance of doubt any decisions or consents which may be necessary pursuant to a condition precedent or a condition subsequent attached to the consent granted by the Authority on 20 January) in relation to the proposed transaction. The Authority's discretion will not be fettered by the issuance of this decision document or by any statement made within it or in the appendices.

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1. Introduction and background

1.1. This document sets out the decision of the Gas and Electricity Markets Authority (the Authority) on the four applications submitted by Transco plc (Transco) under Amended Standard Condition (ASC) 29 of its Gas Transporter's (GT) licence.⁶ These applications request consent from the Authority to dispose of four of its gas distribution networks (DNs) to four wholly owned subsidiary companies, the shares in which would subsequently be sold to third party purchasers.⁷ The applications submitted by Transco were considered at a duly convened meeting of the Authority on 20 January 2005 and are attached to this document as Appendix 1.

1.2. The Authority's assessment of Transco's applications involved careful consideration of amongst other things (and without limitation):

- ◆ the Final Impact Assessment (Final IA) on potential DN sales which was published for consultation in November 2004;
- ◆ the responses to the Final IA; and
- ◆ direct representations which it has received (in response to consultations undertaken by Ofgem).

1.3. The Final IA represented the culmination of a detailed examination of the potential costs and benefits, to customers, arising from the sale of one or more DNs by National Grid Transco (NGT). It also set out a proposed regulatory, commercial and operational framework that could be adopted to protect the interests of customers in the event that DN sales were to proceed. This framework is one that was developed following consultation on a series of Regulatory Impact Assessments (RIAs) which considered specific aspects of the

⁶ In November 2004 (pursuant to applications from Transco in connection with DN sales), without fettering the Authority's discretion in relation to DN sales, five additional GT licences were granted to Transco. As a result, Transco currently holds six GT licences. As at the date of this document all gas transportation assets are operated pursuant to Transco's original GT licence. The new licences, whilst active, do not relate to any particular GT assets owned or operated by Transco. Transco's applications for consent were made under ASC 29 of the original GT licence.

⁷ Transco also applied for consents under Paragraph 3 of Schedule 3 to the Gas Act 1986 (the Gas Act) to permit it to dispose of land (relating to the four relevant gas networks) that it has acquired compulsorily, to its four wholly owned subsidiary companies.

regulatory, commercial and operational arrangements were DN sales to proceed. The Final IA was intended to assist the Authority in making its decision on whether to consent to Transco's applications for consent to dispose of the assets of the four relevant DNs.

- 1.4. The Authority's decision on Transco's requests has been arrived at having had due regard to its statutory objective and duties as well as its public law duties. In addition, the Authority has taken into account the statutory and licence obligations of gas transporters.
- 1.5. At its meeting on 20 January 2005 the Authority:
 - ◆ granted its consent to Transco's applications under ASC 29 of its GT licence and Paragraph 3 Schedule 3 to the Gas Act;
 - ◆ endorsed the previous decisions that it had reached in 2004 regarding the regulatory, commercial and operational framework that would be necessary to protect the interests of customers in the event that the sale of one or more DNs proceeds; and
 - ◆ concluded that its consent should be granted subject to certain conditions, which are set out in detail in chapter 4.
- 1.6. In considering the regulatory, commercial and operational framework, the Authority endorsed the continued development of the enduring offtake arrangements for the allocation of National Transmission System (NTS) exit capacity and offtake flexibility through the DN sales process and concluded that the proposed arrangements are reasonable and proportionate and protect the interests of customers. However, the Authority also concluded that the implementation of the enduring offtake arrangements does not need to occur prior to the completion of the DN sales transaction. Instead, the Authority has decided that the enduring offtake arrangements must be implemented by September 2005.
- 1.7. Consistent with this decision, the Authority has imposed upon Transco conditions to its consent to secure the implementation of enduring offtake arrangements (which include the enduring NTS exit capacity and NTS offtake flexibility arrangements) on a best endeavours basis by 1 September 2005.

These conditions are intended to apply within the period prior to hive down and share sale. In addition, it intends to propose a series of licence obligations on Transco and the DNs to achieve implementation of the enduring offtake arrangements (which include the enduring NTS exit capacity and NTS offtake flexibility arrangements) on a best endeavours basis by 1 September 2005. These conditions are intended to apply in the period following the hive down of the DNs into Transco's four wholly owned subsidiary companies. The conditions and proposed licence obligations are described in more detail in chapter 3.

- 1.8. This document constitutes a notice of the Authority's reasons for its decision which it is required to set out under section 38A of the Gas Act 1986.
- 1.9. It is noted that the proposed DN sales transaction is also subject to the consent of the Secretary of State under ASC 29. The Secretary of State issued this consent on 27 January 2005.
- 1.10. In addition, in order for DN sales to proceed, the Health and Safety Executive (HSE) will need to consider a revised Transco safety case for its NTS and retained DN businesses, as well as safety cases for the four wholly owned subsidiary companies to which DN assets are to be hived down. In addition, the purchasers of the DN businesses also need to have their safety cases accepted by the HSE before they can take over the operation of these businesses.

Document outline

- 1.11. This document is structured as follows:
 - ◆ Chapter 2 provides a summary of the respondents' views to the consultation on the Final IA;
 - ◆ Chapter 3 sets out the reasons for the Authority's decision; and
 - ◆ Chapter 4 outlines the conditions which the Authority has attached to its consent and the way forward.

2. Summary of respondents' views on Final IA

2.1. This chapter contains a concise summary of each of the responses that were submitted in relation to the Final IA consultation by interested participants. The summary does not include responses that were submitted to Ofgem on a confidential basis. The summaries cover responses received from:

- ◆ NGT;
- ◆ Potential purchasers;
- ◆ Shippers/suppliers;
- ◆ Storage providers;
- ◆ Industry groups;
- ◆ Consumers; and
- ◆ Consumer groups.

2.2. The summaries set out below have been provided by respondents to the Final IA. In some cases, these summaries were amended with the consent of the respondent to ensure that they are reflective of all of the issues that respondents included within their submissions in relation to the Final IA consultation. In some cases, respondents did not provide a summary as part of their response to the Final IA consultation. In these instances, Ofgem prepared a summary which was then discussed and agreed with the relevant respondent.

NGT

2.3. 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.

- 2.4. 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

- 2.5. 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.
- 2.6. 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 sectors⁸. 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.
- 2.7. 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

⁸ 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.

peers in this respect, with customers ultimately benefiting from an enhanced level of performance and customer service.

2.8. 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.

2.9. 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; and
- ◆ DN sales can also be expected to benefit consumers through efficiencies in capital and replacement expenditure and improved customer service.

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

2.11. We also consider that Ofgem's proposals for reform of offtake and interruptions arrangements are helpful and will deliver benefits to customers (compared with the no sale option) in a number of areas, namely:

- ◆ more accurate investment signals leading to more efficient investment in the NTS and more efficient operation of NTS capability; and
- ◆ more efficient investment and operation of DNs resulting from the ability of DNs to trade off the costs of investment in their own networks with the costs of securing capacity from the NTS;

- ◆ removal of distortions that dilute market incentives to resolve supply/demand imbalances which would thereby remove an inefficiency of the wholesale gas market.

Analysis of Industry Costs

- 2.12. Whilst 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.
- 2.13. 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

- 2.14. 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.
- 2.15. 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

- 2.16. 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

- 2.17. 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 from the sales and therefore best protects the interests of gas consumers.
- 2.18. 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.
- 2.19. 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.
- 2.20. 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

- 2.21. 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.
- 2.22. We consider that the long term arrangements for NTS exit capacity 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 providing incentives on the NTS to trade off investment in new capacity against the cost of buying back capacity through demand management contracts.
- 2.23. We also support the proposal for moving to a regime that creates a distinct commercial flexibility product. We consider that the option of retaining the flexibility product bundled with the NTS capacity product would give rise to significant additional costs for operating the NTS which would ultimately fall upon customers. The release of a long term commercial flexibility product will enable NTS direct connects and DNs to signal the value they place on offtake flexibility thus providing efficient financially back investment signals to the NTS.
- 2.24. In terms of interruptions we consider that the proposed reforms will enable users to signal the value they place on offering demand management services. The proposed arrangements should facilitate efficient investment in the NTS by allowing it to trade off efficiently the costs of investment against the costs of buying back capacity through demand management contracts.
- 2.25. 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

- 2.26. 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.
- 2.27. In particular, we consider that the framework clearly allocates responsibilities for planning, development, maintenance and operation of the NTS and DN networks. In addition, the offtake arrangements also provide clarity as to the roles and responsibilities at the NTS/DN interface. Further, the offtake arrangements should also assist the NTS in developing a secure and efficient network going forward through the provision of long term investment signals for exit capacity and offtake flexibility.

Business Separation

- 2.28. 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.
- 2.29. Ofgem is rightly concerned to ensure that these issues are adequately addressed.
- 2.30. 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.
- 2.31. 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.

Potential Purchasers

Cheung Kong Infrastructure / United Utilities

- 2.32. 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.
- 2.33. 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.
- 2.34. 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.
- 2.35. We concur with Ofgem's analysis of the benefits and we believe that Ofgem has erred on the side of prudence (i.e. estimated high) when assessing likely industry costs. Clearly there would be additional costs for shippers but cost and complexity will be mitigated by creation of the Agency. 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.

- 2.36. 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. We believe that the impact upon the wholesale market will be positive and this will, in turn, stimulate retail competition. We further believe that the stringent HSE requirements on the approval of safety cases will provide an opportunity to improve safety and security of supply.
- 2.37. 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 (e.g. retaining centrally supply point administration and the uniform network code) and the structural separation of the NTS and RDNs that mitigates these risks and helps ensure that the identified benefits will be realised.
- 2.38. We fully support the arrangements proposed for booking NTS exit capacity although there are still some outstanding issues that require clarification to enable us to fully commit to the offtake arrangements. If this area were to be separated from DN sales, this would reduce the risk of timetable delay.

Macquarie Gas Networks

- 2.39. MGN Gas Networks (UK) Ltd (MGN) has signed an Option Deed with National Grid Transco (NGT) to acquire the Wales and the West (W&W) Distribution Network (DN) being sold by NGT.
- 2.40. We agree with the conclusions in the final Impact Assessment (IA). We have provided a number of comments, and in summary:
- ◆ we support the assessment and the conclusions reached. In particular we believe that the assessment of benefits associated with the sale process has rightly been conservative, and that this provides a degree of

robustness against concerns that some of the benefits are hard to quantify. Given that the quantum of benefits is well in excess of the quantum of costs, in all but one of a number of scenarios, we believe that it would be difficult to determine that the sale process will not yield overall benefits to customers. Further, the one scenario where benefits are less than costs is not only very unlikely, but were it to occur the safety net provisions described briefly in the IA would come into effect, thus protecting customers. We also believe that the benefits identified can only be realised if the sale is to proceed; we do not think it realistic to assume that they can be forced onto NGT were it to remain as the single entity providing transportation services as it does now;

- ◆ we believe that the IA is a sensible digest of the position reached to date. It summarises the conclusions of other consultations, presents recent developments in thinking that have taken place in fora such as the Development and Implementation Steering Group (DISG) and does not introduce new policy proposals not already canvassed in that group or elsewhere;
- ◆ we also believe that the process to date has been open and participative. A number of Consultation Papers, augmented where appropriate by Open Letters, and supported by a variety of expert groups and more recently NGT-led development groups, have allowed all concerned to express their views, usually more than once;
- ◆ in a number of areas, we comment that our support is qualified until we see more details. It is important to note that we do not believe it appropriate for the Authority to wait for the emergence of those details before coming to a decision. In a complex programme of this nature, at any point in time detail will remain to emerge and we believe that enough has been done to date for there to be confidence that the assessments are well-grounded and can support a contingent decision to proceed. Furthermore the Authority has established processes to manage the continued development of detailed policy and associated business rules, and to ensure that the conditions attached to any approval are fulfilled;

- ◆ we would like to see the conditions precedent to the sale identified in full as soon as possible, recognising that in a process such as this further conditions may emerge as and when issues are determined in more detail;
- ◆ MGN is supportive of the reform efforts being conducted as part of the sales process. We are concerned, however, that a series of changes, each justified on its own merits, when taken together could create a serious burden that might delay completion. We therefore suggest that where feasible conditionality might require undertakings to deliver certain aspects of reform after hive down and completion.

2.41. Finally, we can confirm that we strongly support the sale option presented in the IA, as we believe that it will deliver genuine and demonstrable benefits to customers.

2.42. We would be grateful if these comments could be brought to the attention of the Authority.

Scottish & Southern Energy

2.43. SSE agrees that there is potential for substantial net benefits to customers to be realised by the proposed DN sales by the introduction of comparative regulation. Indeed, the value of comparators in setting price controls was most recently illustrated in the electricity distribution price control final proposals where analysis can show that the removal of the efficiency frontier company would have resulted in an increase in operating cost allowances of some £19m/year across the industry. This would indicate an NPV of comparative regulation for customers of around £275m from the current electricity price control.

2.44. In the main, SSE supports the proposed regulatory and commercial arrangements that would support the DN sales process. However, we are very concerned that the proposed NTS flexibility product adds substantial complexity and risk to both the gas and electricity trading arrangements and therefore competition, the impact of which has not been adequately assessed at this stage. We also believe that the complexity of the proposed arrangements could pose a real threat to the completion of the sales process within the allotted timescale. We therefore

advocate that a more simple, rules based regulatory approach is adopted to deal with the allocation of NTS flexibility, with more substantive reform to follow at a later date if the perceived concerns materialise.

Shippers / Suppliers

British Gas Trading

- 2.45. British Gas Trading's (BGT's) view of the project has not changed; in essence we are indifferent as to whether NGT should be permitted to sell 4 networks provided net benefits to customers can be assured. We believe that the Authority should not allow the sale unless they are satisfied that these net benefits will be delivered.
- 2.46. If the Authority consents to sale in January 2005, it seems likely that conditions would be attached. In any case, BGT considers it would be appropriate to plan a go/no go decision prior to hive down, such that if NGT has not fully met the Authority's conditions, DN sale is delayed. BGT would request that the Authority considers the following areas in its deliberations:

Pass through of benefits

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

Attribution of Costs and Benefits

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

- 2.49. It is also relevant here to consider in more detail, whether the potential for benefits in the absence of sale has been properly assessed and discounted in the light of the additional information now available. In view of the lack of clarity, BGT considers that the risk of double counting benefits, which are attributable to price control separation is high, and hence that there is a risk the IA may be flawed. However, BGT notes that capital expenditure benefits have not been quantified, and that such benefits should be quantified as early as possible.
- 2.50. Overall BGT is encouraged by the way that Ofgem has tried to address participants' concerns in respect of costs. However, BGT believes that the cost impacts have been under-estimated in areas such as metering, connections, siteworks and that a lack of full information on exit reform means that the costs have not been properly evaluated.

Timescales

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

Impact on industry participants

- 2.52. BGT is concerned that the impact of the proposals may be damaging to small shippers / suppliers and notes that the proposals will also have a considerable impact upon IGTs. Furthermore, BGT notes that the impact upon competition could be neutral but is unlikely to be positive.

Uniform Network Code ("UNC")

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

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

Offtake arrangements

2.54. BGT continues to have concerns in respect of the correct placement of commercial, operational and technical matters in the UNC or ancillary documentation. Furthermore, BGT believes that the arrangements for NTS Direct Connects are overly complex and likely to prove costly and unworkable in practice.

BP

2.55. BP has significant concerns about the IA and its likely impact. We do not support the existing proposals. Our concern is that, should consent be given to DN sales, a robust and beneficial implementation is achieved.

2.56. These proposals lack significant amounts of detail. With this lack of detail and high regulatory workload arising from optimistic timetables, it is not practicable to comment comprehensively. BP's comments are therefore high level.

2.57. BP believes that the Exit and Offtake elements of the proposals should be considered separately and are not a pre-requisite for DN sale.

2.58. BP has serious concerns about the flexibility product. It is insufficiently developed or understood. We cannot support the product as currently presented.

2.59. Ofgem estimates potential benefits over 18 years to be between £80m and £500m (an extremely wide range) with a base case of £225m (or c60p /customer p.a.). It would be more realistic to consider a much shorter time-frame of say one price control period.

- 2.60. 95% of base case benefits are from introducing comparative regulation. A proportion of these benefits would have accrued through introducing separate price controls, without any sale. This proportion should be excluded from the benefits of the 'sale option'.
- 2.61. Ofgem believe shipper costs "could be scaled down". As fully detailed proposals are not available to assess, we conversely argue there is greater probability of under-estimation. Furthermore we are concerned that the imposed regulatory burden significantly increases the probability of errors and omissions and may result in remedial costs for the industry and customers.
- 2.62. BP is unconvinced by the proposals to book exit capacity three years ahead.
- 2.63. With regard to increases in industry fragmentation, this will inevitably lead to increased shipper costs which will be passed through to customers, and inevitably incentives upon GTs to operate the GB network as a whole in an optimal and co-ordinated manner will become more limited.
- 2.64. With regard to competition, it is our view that excessive regulatory burden constitutes a potential barrier to new market entrants, and with the additional complexity and administration associated with DN sale, we question whether the overall impact of DN sales is beneficial to competition.
- 2.65. If security of supply on both a long term and short term basis is to be maintained at current levels, separation of DNs provides significant challenges that must be comprehensively addressed.
- 2.66. Finally, it is important that customers recognise that should Ofgem's cost estimates prove inaccurate, variances will be passed on to customers. There is no guarantee that potential benefits for customers will materialise.

EDF Energy

- 2.67. A DN sale under appropriate conditions would be in the interests of customers. A change of ownership would likely lead to significant savings but two caveats need to be addressed before EDF Energy can support a sale. The first is assurance that a start is made in securing benefits at the next price control and the second is that the current pace of reform is too ambitious and hasty which could lead to legal and practical problems and negate the expected benefits.

- 2.68. The proposals for exit reform go well beyond those required for DN sales and are being implemented with insufficient consideration. The proposals are unfair between DNs and NTS direct connects and could contribute to a price rise. EDF Energy considers it is too risky to rush exit reform through on DN sales timetable without the normal consideration of parties' views that is required in relation to a code mod. This is especially relevant as a similar mod (mod 527) was previously withdrawn.
- 2.69. EDF Energy urges the Authority to decouple exit reform from DN sales to allow shipper concerns to be properly addressed. Consider that it may be sufficient to implement non discrimination conditions within the existing system and undertake offtake reform at a later date as current proposals will introduce unnecessary complexity and cost. These costs are not incorporated within the analysis in the Final IA and should be included as they may significantly reduce any benefits.
- 2.70. Envisage there will be a fall in market entrants due to the complexity of arrangements which will create a barrier to entry and may stifle wholesale competition.
- 2.71. The introduction of a diurnal flexibility mechanism is discriminatory against direct connects as they do not have the flexibility in their pipelines to manage a 1/24th flow rate where DNs can. In addition, large DN offtakes will not be subject to same flexibility charging regime which may send signals for more embedded gas fired generation capacity to be built on DNs rather than NTS. The flexibility product will hinder the efficient operation of the electricity industry and cause price rises in both gas and electricity as a new level of complexity is introduced. It will be hard for electricity producers to predict the flexibility needed within day, three years ahead and therefore risk management systems will be needed to manage the risk of not buying flexibility, especially for small shippers. Ofgem should undertake a separate IA regarding flexibility.
- 2.72. Have concerns that Ofgem has revised its position regarding legal separation and while EDF Energy considers that there may be merit in the conclusion that has been reached it does not see why Ofgem cannot apply the same rationale to the potential for discrimination in relation to offtake arrangements.

- 2.73. Have concerns that Ofgem has not chosen to include an independent member on the board of the agency. A tenth independent member would balance out voting rights.
- 2.74. EDF Energy is also concerned about the limited emphasis that has been given to metering. There seems to be an assumption that the existing arrangements can be 'lifted and shifted' but the issues are complex and time will be needed to resolve them. A number of specific metering concerns remain outstanding.
- 2.75. Believe that costs will be loaded upfront to protect retailers' gross margins and while customers will absorb the direct cost impact of a sale, benefits remain uncertain as the industry may have restructured by then.
- 2.76. The proposed 'private standard' special conditions go outside of the powers in the Act.
- 2.77. Have concerns regarding the way Ofgem has managed DN sales. In particular, due process has not been followed when turning Network Code into the UNC while the development of exit and offtake rules has also taken place outside of the code in ad-hoc groups. Much policy has also been formed through the DISG which has no formal powers to dictate policy and has provided insufficient time to review documentation.
- 2.78. In addition, the high pace of change has been detrimental to the process and greater costs could be incurred if the industry does not understand the details of reform or has not implemented the necessary changes prior to a sale. While the change of ownership may discover efficiency savings these could be negated if arrangements are introduced without regard to unintended consequences.

E.ON UK

- 2.79. E.ON UK offers qualified support for the sale. E.ON consider that, overall, the costs and benefits included within Ofgem's Final IA are reasonable given the assumptions made, especially as the conclusions reached sit between those previously reached in studies undertaken by NGT and a sceptical shipper. However E.ON states that it is difficult to see whether theoretical gains will actually be realised and, given this, any potential costs should be kept to a minimum. In this regard it considers that most of the additional costs to shipper

/ suppliers (£102 m base case) could be avoided by keeping the current contractual arrangements between Transco and shippers whole as described in detail in a paper by Powergen to the DISG on 3 February 2004.

- 2.80. E.ON considers that 5% of the benefits of a potential DN sale will arise from changes to the commercial arrangements but considers that these changes are the source of the majority of additional cost to shippers and suppliers. As such, E.ON believes that administered rather than commercial offtake arrangements, in line with those originally proposed by Transco, should be maintained in order to reduce costs. E.ON stated that whilst this may forgo a small proportion of potential benefits it would avoid many complexities and risks. E.ON indicate that the development of offtake arrangements as well as the allocation of roles and responsibilities between network owners should focus only on what is expedient and necessary to facilitate a DN sale.
- 2.81. With respect to the approach regarding Roles and Responsibilities E.ON favours an approach where the National Transmission System (SO) continues to take the lead responsibility for system operation across the transmission and distribution systems as opposed to an approach under which DNs actively manage system operation within their own networks. E.ON is particularly concerned in this respect that this will result in individual DNs diverging in the development of their market rules and charging methodologies. E.ON believes that Ofgem's chosen approach to roles and responsibilities will act as a strong driving force on fragmentation of rules and processes.
- 2.82. In relation to the Agency and Governance proposals, E.ON welcomes Ofgem's proposals. E.ON consider that successful implementation of Agency and Governance arrangements and the national coordination of charging methodologies will be essential to avoid cost escalation to shippers. E.ON emphasises the need for robust regulatory oversight to avoid fragmentation of rules and charging methodologies. E.ON also have concerns that the market may become more fragmented over time and estimate that any break up of common agency activities could lead to costs as high as £730m as suggested by the Gas Forum cost study.
- 2.83. With respect to the offtake arrangements E.ON considers that Ofgem's insistence on radical reform will place unnecessary costs on shippers and may delay a

potential DN sale. It considers that it is hard to comment on the current proposals as they are not fully developed. It indicates that E.ON did not anticipate extra costs associated with the complexity of the Offtake arrangements in its pro forma response to the Final IA, including costs related to managing the trading of capacity as well as monitoring within-day capacity and flexibility. E.ON therefore suggests doubling its estimate of costs in this area.

2.84. E.ON states that Ofgem is concentrating on the potential for undue discrimination in its development of offtake arrangements, which is an area that customers are not greatly worried about. E.ON would be content with the adoption of administered offtake arrangements and considers that, combined with information transparency, normal regulatory oversight of monopoly activities and robust internal separation, it would offer the lowest cost solution.

2.85. E.ON indicates that the current proposed reforms will mean NTS connected customers will face a harsher regime than DN connected customers and states that this in itself represents a form of undue discrimination. In terms of the flexibility product E.ON comments that it is inconsistent to require those off-taking gas to buy a flexibility product whilst those delivering gas onto the transmission system can flex within-day.

2.86. E.ON is content with the current arrangements for 'bundled' NTS capacity services with no secondary flexibility product and no exit capacity regime changes. E.ON indicates that the proposed offtake arrangements will produce greater uncertainties for generators and may discourage both generation and storage investment if the reliability of new supply is threatened by the proposed arrangements. E.ON also questions whether shippers will make longer term capacity bookings and whether Transco will obtain investment signals.

2.87. E.ON is sceptical that balancing costs will be reduced in gas and electricity. It considers that the opposite effect may result as reducing gas demands through indirect buy-backs of capacity are unlikely to be effective and requiring users to purchase within-day flexibility in advance will introduce rigidities that will impede a generator's ability to offer electricity into the electricity spot market or balancing mechanism.

2.88. With respect to general process points, E.ON is concerned that tight timescales and financial imperatives mean Transco will force a rapid pace and probably cut

corners. E.ON is also concerned that discussions on the Uniform Network Code proposal and exit capacity changes are taking place outside of established formal industry processes and that the modification proposal to transform the Network Code into a short form network code that references the Uniform Network Code may be made at the eleventh hour with little time for consultation. In addition, it raises concerns that Ofgem may have exceeded its powers in establishing a private Collective Licence Modification process.

Eni UK

- 2.89. Eni UK say “no” to the sale of the Distribution Networks and strongly oppose the associated changes proposed. Eni UK believe that as the sale of the Distribution Networks will result in major structural changes within the industry, which have consequential effects on all parties, it is crucial to carry out substantial assessments and reasonable consultations, before the sales can be approved.
- 2.90. Eni UK is concerned that Transco’s processes are already taking place as though regulatory approval has been given for the sale to proceed. Furthermore, the way the current processes are being managed lacks co-ordination between the groups covering the different areas (e.g. Exit Regime forum and Gemini forum).
- 2.91. Eni UK notes that simultaneous consultations during a known peak holiday period is unreasonable and creates human resource issues for shippers and suppliers. Furthermore, Eni UK is concerned that the cost benefit assessment performed within the Final IA is based on ‘95% assumptions’.
- 2.92. Eni has previously indicated that it believes that the substantial costs of implementing the DN sales (as such costs will arise among participants in the gas industry) far outweigh any benefit liable to arise to either the gas industry, or as a consequence to consumers. The case for the cost benefit analysis remains unproven.

Gaz de France

- 2.93. Gaz de France ESS is in favour of the no sale option as we do not have sufficient confidence that the program, as currently structured, will deliver benefits to customers or create a more efficient regime.

- 2.94. Consider that modelling the auction regime for exit capacity on entry capacity will create an artificial market. While at entry there are a number of participants making the use of market principles sensible, at exit it is likely there will only be a single bidder. There is also undue discrimination between auction participants i.e. DNO's and shippers
- 2.95. Large NTS direct connects are unlikely to be able to forecast Long Term capacity requirements to allow them to commit to an auction regime. Gaz de France ESS is concerned that exit capacity may not be the best way to give NGT proper investment signals. Also, that the proposed matrix of exchange rates does not yet exist and could give rise to arbitrage opportunities.
- 2.96. Gaz de France ESS does not believe that flexibility is crucial to the delivery of transparent exit arrangements. Have concerns that a Cost Benefit Analysis (CBA) has not been completed and believe that the arrangements would add disproportionate costs.
- 2.97. Gaz de France ESS has concerns regarding flexibility and its implications for security of supply. Storage providers and shippers that flow gas from storage may be subject to penal flow rate charges and therefore be incentivised not to flow gas when it is needed most. We also consider that flexibility may be a threat to electricity security of supply where CCGT plants are disincentivised from increasing output due to gas flexibility products.
- 2.98. If 95% of the benefits identified are to be achieved through comparative regulation it is impossible to argue a Cost Benefit Analysis (CBA) case for the remaining 5% of benefits to be achieved as a result of exit reform as this where the majority of costs arise. Gaz de France ESS believes that costs are likely to be underestimated as figures submitted in relation to the shipper pro forma were a best estimate based on proposals at that time. It would be fair to allow shippers to review their estimates given development of proposals. Clarification is needed on the additional benefits of DN Sales over and above separate regional price controls.
- 2.99. The complexity associated with the Offtake arrangements is unwanted by customers and is an unnecessary complication which will likely create a significant barrier to entry and may provide small shippers with an incentive to exit the market due to increased costs.

- 2.100. Believe that the interim arrangements i.e. minimal change, regarding flow flexibility, fit well with a low cost enduring solution.
- 2.101. Crucial information is not currently available and the timetable for development and implementation of the proposals are unrealistic given the magnitude of changes required; this introduces significant risks. Shipper participation has also been limited due to finite resources available and as such there is a risk of oversight which could lead to flawed arrangements. In addition, Gaz de France ESS does not consider there has been satisfactory consideration or consultation given the enormity of the proposals.
- 2.102. Concerned that consultation regarding exit reform has been taken outside of the due process of Network Code in newly formed groups, which have no formal standing under Network Code.

RWE

- 2.103. Based on Ofgem's analysis, and assuming that at least the low case assumptions for improvements in controllable opex are adopted in future price controls, DN sales is likely to create a positive net benefit to customers. This is despite the fact that we believe the consequential benefits that have been claimed should be discounted and that shipper costs may have been under estimated.
- 2.104. Ofgem have reasonably demonstrated that customers are unlikely to be worse off in the event of DN sales. We therefore believe that NGT should be allowed to proceed with their proposed DN sales.
- 2.105. We do not support the sale option as presented in the RIA as we believe that it would be possible to further increase any potential net benefits by not introducing market-based exit arrangements into the unified network code.
- 2.106. We are concerned that the proposed timetable for DN sales will not allow sufficient time for adequate consultation on a number of outstanding issues. We would therefore ask that the Authority give serious consideration to extending the published timetable by three months.

Key issues and assessment of the costs & benefits associated with DN sales

- 2.107. Ofgem appear to have attributed an improvement in controllable opex of 0.5% to DN price control separation. Any understatement of this efficiency improvement will reduce the benefits attributed to DN sales. Ofgem's base case assumption of a 4.13% average improvement in allowed controllable opex over the next three price controls is challenging, however, it is not inconceivable it can be achieved.
- 2.108. We do not accept the assumptions Ofgem have used in estimating the £17.4m present value of the consequential benefits. We believe the Ofgem's base case assumption should exclude any consequential benefits, particularly as there has been no sensitivity analysis on the benefits.
- 2.109. Ofgem's pro forma on shipper costs had a very short response time and details of Ofgem's proposals for operational flexibility were not fully understood at this time. Shippers views on the costs should therefore be treated with caution and a risk margin of +/- 50% should be applied to these base case costs.

Allocation of roles and responsibilities

- 2.110. We support Ofgem's conclusions in this RIA and believe that the roles and responsibilities of Transco NTS and the DN businesses are clearly defined.

Offtake arrangements

- 2.111. Ofgem clearly stated in this RIA that if the costs of introducing offtake reforms were prohibitively high relative to the benefits, it would not be in customers interests to pursue these further. Ofgem's own analysis suggests this is the case.
- 2.112. The extent of any current and future possible undue discrimination has never been quantified, and so this is not a legitimate reason for insisting that new offtake provisions be made now. If it can be quantified, and is found to be material, other less costly and complex options should be considered first.
- 2.113. We are surprised that Ofgem have changed their initial view that full legal separation is appropriate but accept Ofgem's re-assurance that it is possible to mimic the effect of legal separation by way of licence conditions. We are

disappointed that such assurance in the use of licence conditions to prevent discrimination does not seem to apply to offtake arrangements.

Interruption arrangements

- 2.114. We are disappointed that Ofgem chose to ignore the majority view of respondents that the status quo should be maintained.

Agency and governance

- 2.115. We still believe that the Agency should have a role in ensuring that the process for requesting a new connection is handled in a standard way. In our opinion this is even more relevant now Ofgem propose to introduce GS/OS obligations regarding connections in each transporter licence.

Risks arising from DN sales

- 2.116. We believe it is important to monitor the extent to which net benefits have been realised going forward, and to take ongoing action to mitigate the risks. We would expect Ofgem to make a specific reference in each of the next three price controls on how their proposals compare with the base case assumptions.
- 2.117. Adopting a market-based approach to NTS exit capacity and operational flexibility allocation is unlikely to improve investment signals or lead to lower investment through improved efficiency. It is also possible that dis-aggregating flexibility from capacity will lead to inefficient investment and an increase in electricity balancing charges.
- 2.118. Market-based exit reform could reduce competition in gas supply to NTS direct connects and any significant under or over recovery of allowed revenue arising from the auctions will increase the volatility of transportation costs.

Shell Gas Direct

- 2.119. SGD continues to have no objection to the sale of the DNs. However, we remain of the view that the approach adopted by Ofgem and NGT is likely to increase unnecessarily initial and on-going costs of this change. For this reason, we consider that the “no sale” option should be adopted at this point. This project involves, in effect, today’s consumers (through their shipper/suppliers)

making an up-front loan of an uncertain size for the initial costs of the DN Sale in the expectation that future consumers will be paid back at some unknown rate starting sometime *after* the next price control period.

- 2.120. We consider Ofgem's analysis of the potential net benefits to be optimistic, not conservative. More effort should be made to minimise the risk of potential negative outcomes.
- 2.121. SGD has not submitted costs on exit and flexibility products as the proposals were (and remain) too poorly developed to do proper costings⁹. We consider any costings in this area at this time to be at best preliminary given the state of developments on this, separate, project. A further, full RIA on exit and flexibility will need to be done. Changes to the exit regime will have a significant impact on NTS customers. To the best of our knowledge, Ofgem has not sought information from these customers regarding costs. It is imperative that this information is included before any final decision is made.
- 2.122. SGD also comment that shippers have no information on the future demand of their consumers, particularly as many consumers are only supplied on one or two year contracts. SGD stated that shippers will not be able to assist consumers in determining whether to book capacity as this could be seen as providing financial advice under the FSMA. SGD also has concerns that customers do not understand the implications of exit reform and are being obliged to bid ahead to ensure that they can continue to have their current firm capacity rights maintained at LRMC prices.
- 2.123. SGD state that there are many areas where consumer costs will increase directly as a result of the sale which have been disregarded, minimised or not fully understood by Ofgem.
- 2.124. The inclusion of an agency will mitigate some problems which will arise with customer transfers. It does not remove them and the risk of a negative impact on customer transfers cannot be ignored. We remain concerned that the combined effects of the introduction of RGMA in 2004 and the DN Sale in 2005 could lead

⁹ We note that the "detailed explanation" of the proposals relating to offtake flexibility in one of the appendices has been published months after Ofgem requested cost information.
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to significant problems with data quality. The additional impact of the DN Sale must be considered.

- 2.125. The changes being introduced through this project could have negative impacts on IGTs undermining efforts to extend the network. This could have a negative impact on fuel poverty.
- 2.126. Ofgem has not followed due process in progressing this project. For example, commitments made by the Authority in previous document regarding how the changes to the exit regime would be progressed have been disregarded to be replaced with an approach without normal industry governance. Other issues raised in writing with Ofgem have not been addressed.
- 2.127. In keeping with this, the process adopted is not consistent with the Authority's Gas Act obligations in respect to the principles of best regulatory practice. These issues have been raised formally and not addressed; the Authority should set out how these principles have been, and are being, met in its final decision.
- 2.128. We remain disappointed that no member of the Authority has been willing to meet with industry participants to discuss issues and concerns throughout this process; this is not consistent with a transparent and accountable process.
- 2.129. Ofgem's view that there is a high potential for discrimination appears to be a recently developed justification to change the exit regime; given that previous reasons for changes could not be sustained. We continue to advocate that changes are only proposed once problems have been clearly identified and understood.
- 2.130. There remains a need for a detailed implementation plan to be developed between NGT and Ofgem which fully sets out the dependencies, timescales etc. While it may be that this is NGT's project, it remains Ofgem's responsibility to ensure that the best result is achieved in the interests of consumers which must include minimising risk and costs associated with a poor implementation. Ofgem also has a responsibility to ensure that NGT is not able to use its position in such a way that has negative impacts on the competitive market participants.
- 2.131. The plethora of documents, consultations, papers, workgroups etc, makes it extremely difficult to keep up with this project despite extra resource put on it.

This in part reflects the fact that the project was not properly scoped initially and that extra areas were added later. This approach is not indicative of a transparent process but instead undermines the ability of market participants to understand and effectively respond to the complex changes being proposed; the quality of the consultations being undertaken has been compromised.

2.132. We reiterate Shell Gas Direct's position is that we have no objection to the sale of one or more NGT's gas distribution networks. We consider this to be a commercial decision by NGT. However, given the extent of unresolved issues, risks to this project and potential for costs to outweigh the benefits, at this time we consider the status quo, "no sale" option to be in the best interests of consumers.

ScottishPower

2.133. SP believes that the proposed sale of gas distribution networks (DN) is not in the interests of customers and would inevitably result in an early increase in retail gas prices because of higher costs imposed on gas shippers and suppliers as a direct consequence of the sale. SP believes that the Authority would be failing in its primary duty to protect and advance the interests of consumers were it to approve the proposed sale.

2.134. By Ofgem's own analysis the proposed sale would involve significant upfront costs while any potential benefits would be much less certain and, even in the most optimistic scenario, would not be realised for several years. Had Ofgem been able to secure more tangible benefits for customers by way of an early change to the DN price control or other verifiable customer benefits to offset the increase in supplier and shipper costs, then SP would have supported the proposed sale. Ofgem has not proposed or secured any verifiable benefits for customers and has accepted that no customer benefits will be achieved until after the next price control in 2008. By contrast the additional costs resulting from the proposed sale will be incurred in the short term and with much greater certainty than any of the longer term benefits assumed by Ofgem in its Impact Assessment (IA).

2.135. We note that 95% of the benefits assumed by Ofgem are attributable to tighter regulation, which Ofgem believes could only be achieved through comparative

regulation. We do not accept that Ofgem could not tighten the regulation on Transco to drive many of the efficiencies that Ofgem assume could be achieved without the need for the industry to take on the substantial cost burden associated with the proposed sale.

- 2.136. Widespread and detailed changes will be required to operating practises and contractual arrangements as a result of metering, new connections, siteworks and emergency procedures. To support these activities through Shipper/Supplier systems, adequate time is required to develop, test and implement these changes. SP believe that the timescales envisaged do not allow for a thorough impact assessment to be carried out in order to ensure that the customer does not suffer as a consequence of a rushed implementation. Furthermore, SP believes that potential costs in these key areas could be understated due to the lack of detailed requirements that will be needed to operate these activities. Transitional arrangements for metering will also have cost implications.
- 2.137. There has been a series of impact assessments on this issue incorporating a wide range of assumed benefits. We believe this confirms the uncertain nature of the benefits that Ofgem has assumed. It would be appropriate to apply a much higher discount rate to the assumed benefits (when compared to the assumed costs) to reflect this uncertainty when assessing the NPV of the proposed sale. We believe that a more realistic IA would have led Ofgem to the conclusion that, without verifiable and early customer benefits directly attributable to the sale, the “no sale” option is in the best interests of gas consumers, with respect to both cost and service.
- 2.138. We do not believe that Exit regime reform is necessary as part of the DN sales process, and believe it should be treated independently of the sale process and on this basis not figure in any IA or be central to the decision on sale or no sale.
- 2.139. We are also concerned that efficiencies obtained by the purchasers of the DNs and the proposed framework of arrangements for their shareholders could potentially compromise safety and security of supply. Finally Ofgem should note that the additional investment costs imposed on shippers and suppliers will be particularly difficult for smaller companies to bear and as a result, competition in the industry is likely to be adversely affected throughout the gas supply chain.

Statoil UK

- 2.140. STUK indicated that it cannot support the sale of the DNs by NGT in its present form. STUK stated it was very concerned over the complex nature of reform to the exit capacity arrangements and the introduction of the flow flexibility product. It indicated that the speed of development is very concerning and the need for such complex arrangements is questionable.
- 2.141. In terms of flow flexibility, STUK stated that instead of implementing a complex and untested flow flexibility product it would be better to rely on the Authority enforcing Transco's licence obligations not to discriminate.
- 2.142. STUK also questioned whether NTS direct connects would be able to determine their long term capacity and flexibility requirements to be able to participate in long term allocations of these products. STUK indicated that there is a high degree of uncertainty for long term decision making associated with these customers and such rules could impact their competitiveness with other non-UK based companies.
- 2.143. STUK said that DNs would not face this degree of uncertainty and have clearly different requirements to direct connects (customers, storage, Interconnectors). STUK suggested that DN's have the option to invest in their networks and avoid the purchase of the flexibility product, whilst direct connects have to modify their behaviour and purchase the product or face an overrun penalty. STUK therefore stated that a blanket approach towards change will not benefit all NTS offtakes in the same way. Further, STUK also raised concerns that the NTS flexibility product would primarily benefit Transco, at considerable cost to the rest of the industry, as it controls the release of the product and the exchange rate at which to trade it. As such, STUK have doubts about the effectiveness of the exit capacity reform and believe the flow flexibility product should not be introduced.
- 2.144. In terms of the cost-benefit analysis STUK indicated that it believed that a significant proportion of the benefits of comparative regulation could be achieved without the sale of DNs, but through licence amendments aimed at driving greater efficiency. It also said that it was difficult to determine the full

costs of DN sales when reform of the offtake arrangements is still being developed.

- 2.145. In principle, STUK do not object to NGT selling a DN. However, STUK does not think that the introduction of the flow flexibility product is in the best interests of our customers and is detrimental to the market.

Total Gas & Power

- 2.146. 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.
- 2.147. 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.
- 2.148. 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 in practice be achievable and further will they only be achievable through the DN sale proposal as opposed to incremental reform? In particular we have considerable doubts as to whether the DN sale will deliver the necessary level of comparators to generate the benefits claimed. More work needs to be done before we will be convinced that the current gas industry can easily be likened to the water and electricity industries when it comes to the potential for similar benefit uplift through comparative regulation.

- ◆ 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%)? Or is this an Ofgem opportunity to introduce its desired reform against the wishes of the industry? If discrimination concerns are real then these should be able to be addressed through business/legal separation but this solution appears to have been discarded.
- ◆ Whether a sale will frustrate the development of competition within shipping, NBP/OCM trading and supply? Past major reforms have taken a long time to bed in, increasing the level of regulatory risk and making the UK gas industry increasingly complex.
- ◆ 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? Fragmentation has in the past raised concerns over safety and divergence of standards.
- ◆ 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? Many different areas are being evaluated in parallel in order to meet an NGT imposed timetable. We are concerned that this is putting excessive pressures on the industry which is likely to result in poor quality decisions and an increase in costs in the long term. Also industry involvement is incorrectly being interpreted as industry agreement.
- ◆ If the sale benefits are so clear, why haven't the major end consumer groups been more vocal in their support?

Storage Providers

Centrica Storage

2.149. Favour no sale option based on proposed offtake rules versus status quo.

- 2.150. Transco consultation on exit business rules and Ofgem's proposals for incentives will better inform the implementation of changes to the exit regime from 2008.
- 2.151. Substantial risk that 'exit' system will not achieve aims due to complexity and cost. Storage and interconnector sites face undue discrimination from proposed amendments. Concerned that Transco may insert the proposed exit regime into the UNC without a modification to support this, allowing Ofgem the opportunity to assess the proposals against the relevant objectives.
- 2.152. Given huge difference between winter and summer demands do not think is appropriate to introduce a system which requires similar effort for exit capacity throughout the year. Believe 'exit' economics should focus on winter balancing and current proposals do not.
- 2.153. If storage users were required to buy firm exit rights and sell their interruption rights Transco would assess the value of this as nil as it would not expect to see a reduction in demand if it exercised interruption on high demand days. Exchange Rate principles are unduly complex and likely to confuse nodal / zonal distinctions.
- 2.154. Use it or lose it (UIOLI) provisions are of critical importance in maintaining consistency of approach. Have fundamental concerns with proposal to make the amount of capacity available on UIOLI a function of capacity sold in LT as runs counter to fundamental tenet behind UIOLI as it would permit hoarding. CSL favours release of UIOLI cheaply at a day ahead stage, up to peak system capacity.
- 2.155. Important that offtake model should send good investment signals at high demand levels. Believe there should be a 'phased' implementation focusing on operations and incentives at high levels of demand
- 2.156. Concerned that offtake proposals are driven by a desire to replicate investment signals on entry, even though the entry auctions are not sending authentic signals. (reference Transco Ten Year Statement).
- 2.157. The Flow Flexibility Product does not recognise the benefits physical swing providers bring to the NTS. Applying a charge for front profiling a nomination

will have unintended and undesirable consequences. Allocating this charge at shared meter points is also problematic.

Industry Groups

Association of Electricity Producers

2.158. The key points of AEP's response are as follows:

- ◆ The offtake and flow flexibility arrangements are insufficiently developed, with many parameters unknown, to enable the Authority to make an informed decision on the DN sale incorporating these arrangements at this time - in particular whether the identified principles can be achieved and benefits delivered;
- ◆ The offtake and flow flexibility arrangements should be decoupled from the DN sale process and be subject to a separate more complete impact assessment. This would mitigate the growing regulatory risk that arises from developing and implementing complex arrangements in dangerously short timescales; and
- ◆ We recognise that new management practices and initiatives will drive the benefits that are likely to emerge from comparative regulation following the DN sale. However, the Authority will have to satisfy itself that those benefits have not been overstated and that, for example, efficiency gains arising from the separation of the LDZ price controls have been adequately considered.

CIA

2.159. CIA remains to be convinced that the sale of Transco's gas distribution networks will result in benefits to gas consumers.

2.160. We are unsure how much can be gained from comparative regulation and how this will be passed through to end-users.

2.161. CIA is concerned with the pace at which reform is being progressed, especially with respect to the exit regime. We request that any amended business rules are assessed to ensure that they are robust and non-discriminatory. CIA, like most of

the gas industry, believes that exit reform should not be treated as a 'gateway issue', although some changes to the arrangements are inevitable.

- 2.162. We require assurance from Ofgem that the new DN owners will not compromise service or investment to make savings.
- 2.163. We would like to see further detail on the compensation which could be offered to consumers if the DN sales failed to produce the anticipated benefits, for instance, the customer safety net.

Gas Forum

- 2.164. Majority of gas forum members do not currently support the sale option.
- 2.165. Benefits of a sale may have been overestimated as in the 'no sale' scenario there is considered to be no change within the industry while some of the costs are not sufficiently considered e.g. metering, flexibility and cost of securing alternative credit.
- 2.166. Large proportion of benefits associated with comparative regulation will be achieved in any case through the introduction of price controls – these benefits should be removed from the analysis.
- 2.167. Do not understand why existing licence conditions would not be sufficient to address discrimination in allocation of exit capacity and flexibility. Proposed approach to offtake arrangements are unduly complex and will introduce significant risk and cost. Impact of commercial booking arrangements for offtake and flexibility not adequately assessed and may have implications under FSA as it relies on shippers booking capacity. Work on offtake arrangements should be decoupled from a DN sale. Existing arrangements should be retained with simple rule-based mechanisms to deal with NTS/DN interfaces. More appropriate and proportional reform could be implemented following a potential sale.
- 2.168. Proposals remain high level and, as such, are unable to develop or implement changes required given the lack of detailed information which raises additional concerns regarding the short timeframes available for this.

2.169. The existing governance arrangements should have been used for development of the UNC as current approach has no standing. In this respect, the gas forum is concerned that the work of the UNC development forum will not be reflected in the UNC.

Major Energy Users Council

2.170. MEUC indicated that, were they required to make a choice, they would prefer the 'no sale' option.

2.171. MEUC raised a number of concerns regarding DN sales relating to quality of service provision and offtake arrangements.

2.172. In terms of the former, MEUC stated that cost savings made by new DN owners may lead to decreases in service quality. MEUC highlighted the recent problems faced by customers following the storms that impacted on electricity distribution networks. MEUC stated that it will be important for Ofgem to ensure that the DNs match Transco in performance with respect to repairs and reconnections.

2.173. MEUC indicated that it had concerns with the offtake arrangements stating that they are overly complex. Specific concerns were raised regarding the offtake flexibility arrangements. MEUC stated that linepack should remain in the control of the system balancer for security of supply reasons and should not be exposed to commercial decisions. MEUC also indicated that the introduction of an offtake flexibility product which attaches financial penalties associated with profile variations within-day would in effect represent a move towards hourly balancing which it opposes.

2.174. MEUC also stated it had concerns with the exit capacity arrangements. It believed the release of a day ahead interruptible product would encourage existing NTS firm sites to rely on this product and freeload thereby passing capacity costs onto LDZ customers. MEUC were also concerned that by placing incentives on the DN not to overbook capacity, this may encourage under-booking which may increase security of supply risks.

2.175. The MEUC indicated that it was generally comfortable with the concept of the Agency and also stated that the principles of comparative regulation providing benefits to customer were sound. However, MEUC indicated that customers

will directly face the costs of DN sales over the next two years whilst the benefits will be spread thinly over a larger period. MEUC added in this context that NGT shareholders should bear all the identifiable industry costs associated with the sale of DNs.

Consumers

BOC

- 2.176. BOC believes that the Authority should not approve the sale unless this results in early clear concrete benefits for gas customers.
- 2.177. BOC feels sure that this is in line with the Authority's view with its principal objective to protect the interests of customers.
- 2.178. BOC is concerned that the costs arising as a consequence of DN sales are certain to arise and that they will occur in the near future whereas the potential benefits are much more uncertain and if they arrive this will be a long way into the future.
- 2.179. BOC hopes that when GEMA are considering the estimated financial and non-financial benefits from a post DN sales regime. In particular that they are able to consider the benefits net of any benefits that could be expect to occur as a result of OFGEM's developing regulation of a system in which DN and NTS assets remain in single ownership. BOC believes that it is unrealistic to believe that no DN sales result in regulation that ossifies.
- 2.180. BOC does not understand why Ofgem has decided not to taken the opportunity to seek customer savings from gas pipeline operators before the end of the existing price control period.
- 2.181. BOC believes that the new systems required for the physical and commercial systems are likely to provide a barrier to entry for new gas suppliers and are likely to hasten the exit of some existing suppliers. This will have a damaging effect on competition
- 2.182. BOC believe that a post DN sales world will put an additional burden of complexity on customers which they can ill afford.

Consumer Groups

Energywatch

- 2.183. Energywatch has no 'in principle' objection to the sale by National Grid Transco of its gas distribution networks. We believe however, that consent to the transaction by the gas and electricity markets authority should be withheld until the interests of existing and future consumers can be adequately protected. It is not, in our view, sufficient to assess potential benefits and the potential costs and arrive at a net benefit. In order to properly protect consumer interests, the authority should ensure that the gross sale price does not include a component which should properly be distributed to consumers in the form of lower future prices or higher standards of service. Energywatch believes the sales above RAV will generate incentives for investment and maintenance minimisation and revenue maximisation which compromise the interests of future consumers. In taking the £5.8 billion sales proceeds, three years before the next regulatory setting, future consumers bear huge risk and at best, the prospect of a relatively trivial benefit.
- 2.184. As presently constituted energywatch is against sale.

3. The Authority's decision

- 3.1. This chapter sets out the Authority's decision on Transco's four applications under both its GT licence and the Gas Act for consent to dispose of four of its DNs to four wholly owned subsidiary companies.¹⁰
- 3.2. The Authority welcomes the comprehensive comments that have been provided by respondents on the cost/benefit analysis, as well as the options regarding the regulatory, commercial and operational arrangements that were outlined in the Final IA.
- 3.3. As noted in chapter 1, the Authority's assessment of Transco's applications involved careful consideration of, amongst other things (and without limitation):
- ◆ the Final Impact Assessment (Final IA) on potential DN sales which was published for consultation in November 2004;
 - ◆ the responses to the Final IA; and
 - ◆ direct representations which it has received (in response to consultations undertaken by Ofgem).
- 3.4. The Authority's decision on Transco's applications has been arrived at having due regard to its statutory objective and duties as well as its public law duties. In addition, the Authority has taken into account the statutory and licence obligations of gas transporters.
- 3.5. At its meeting on 20 January 2005, the Authority:
- ◆ granted its consent to Transco's applications under ASC 29 of Transco's GT licence and Paragraph 3 of Schedule 3 to the Gas Act;
 - ◆ endorsed the previous decisions that it had reached in 2004 regarding the regulatory, commercial and operational framework that would be necessary

¹⁰ As noted in chapter 1, Transco has made four separate requests to the Authority under ASC 29 of its GT licence to dispose of four of the DNs to four wholly owned subsidiary companies. It has also applied for consent under Paragraph 3 of Schedule 3 to the Gas Act to dispose of land that it has compulsorily acquired to its four relevant wholly owned subsidiary companies.
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to protect the interests of customers in the event that the sale of one or more DNs proceeds; and

- ◆ concluded that its consent should be granted subject to certain conditions (these are discussed in chapter 4).

- 3.6. In considering the regulatory, commercial and operational framework, the Authority endorsed the continued development of the arrangements for the allocation of National Transmission System (NTS) exit capacity and NTS offtake flexibility through the DN sales process and agreed that the proposed arrangements are reasonable and proportionate and protect the interests of customers. However, the Authority also agreed that the implementation of these arrangements does not need to occur prior to the completion of the DN sales transaction. Instead, the Authority has agreed that these arrangements must be implemented by September 2005. In order to achieve this, the Authority has imposed conditions to the consent granted to Transco and also intends to propose a series of licence conditions on Transco and DNs to secure the implementation of these arrangements on a best endeavours basis. These are discussed below.
- 3.7. This document constitutes a notice of the Authority's reasons for its decision which it is required to set out under section 38A of the Gas Act 1986. In setting out these reasons, the document also sets out the Authority's response to issues raised by respondents to the Final IA.

Implementation of the enduring offtake arrangements

- 3.8. In order to achieve the implementation of the enduring offtake arrangements by September 2005, the Authority has imposed certain conditions to its consent that must be met before Transco can be permitted to hive down its DN assets to its four wholly owned subsidiary companies, scheduled to occur on 1 May 2005.
- 3.9. For the period following hive down and share sale the Authority intends to propose a number of licence conditions on Transco and the DNs relating to the implementation of the enduring offtake arrangements.

Enduring offtake arrangements – conditions to consent

- 3.10. The first of the conditions to consent relating to the enduring offtake arrangements is that Transco must procure an undertaking addressed to the Authority from NGT, specifying that NGT will, prior to the proposed section 8AA (and related section 23 licence modifications) to the six Transco GT licences becoming effective, use its best endeavours to ensure that steps are taken to implement the enduring offtake arrangements by 1 September 2005.¹¹
- 3.11. The second of these conditions is that Transco must procure undertakings addressed to the Authority from each proposed third party purchaser specifying that prior to the completion of the sale of shares to the new purchaser, such purchaser will use its best endeavours to ensure that steps that are taken to implement the enduring offtake arrangements by 1 September 2005.

Enduring offtake arrangements - proposed licence conditions

- 3.12. In order to cover the period following hive down and the subsequent sale of shares in the DNs to the new purchasers, the Authority intends to propose a number of licence conditions on Transco and each DN regarding the implementation of the enduring offtake arrangements. Transco and the DNs will be required to accept these licence conditions before the hive down can take place.
- 3.13. In particular, the Authority intends to propose licence conditions binding upon Transco and each of the DNs requiring them to use their best endeavours to implement the enduring offtake arrangements by 1 September 2005.
- 3.14. The Authority also intends to propose, as part of the licence condition binding upon Transco, an obligation upon it to procure from NGT an undertaking to the Authority that it will use its best endeavours to ensure that Transco implements the enduring offtake arrangements by 1 September 2005.

¹¹ The enduring offtake arrangements are described in chapter 5 of Ofgem's Final IA. NGT sale of gas distribution networks – Authority decision document
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- 3.15. Further, the Authority intends to propose, as part of the licence conditions binding upon each independent DN, an obligation requiring it to procure an undertaking addressed to the Authority from its ultimate controller that it will use its best endeavours to ensure that the relevant independent DN implements the enduring offtake arrangements by 1 September 2005.
- 3.16. Ofgem proposes to consult upon these proposed licence conditions in February 2005 as part of the proposed Section 8AA and associated Section 23 licence modification proposals to Transco's six GT licences.

Way forward

- 3.17. Following the Authority's decision, a programme will now commence to implement the relevant arrangements. This programme will involve a combination of licence modification proposals to be issued by Ofgem, as well as pricing consultations and network code modification proposals to be issued by Transco. In addition, Ofgem intends to consult upon the legal text of the Uniform Network Code (UNC) in March 2005. An indicative timetable for the implementation programme is included within chapter 4.
- 3.18. Transco will need to ensure that it meets all relevant conditions that have been attached to the Authority's consent regarding the regulatory, commercial and operational arrangements including (without limitation) the enduring offtake arrangements. These conditions are discussed in more detail in chapter 4.

Chapter outline

- 3.19. This chapter outlines the Authority's conclusions on:
- ◆ the overall costs and benefits analysis for DN sales;
 - ◆ the regulatory, commercial and operational arrangements necessary to protect the interests of customers in the event of the sale of one or more DNs.

Overall costs and benefits analysis

- 3.20. This section outlines the Authority's conclusions on the overall costs and benefits analysis from the Final IA and respondents' views presented to the

Authority for consideration at its January meeting. It also sets out the Authority's conclusions on the main issues raised by respondents to the consultation on the overall costs and benefits analysis.

- 3.21. Having carefully considered the responses received to the consultation on the Final IA, the Authority agrees with the analysis set out in the Final IA regarding the potential costs and benefits associated with the sale of one or more DNs. The Authority considers that the base case analysis set out in the Final IA of the potential net benefits to customers of approximately £225m associated with the proposed DN sales transaction, is reasonable and robust with respect to its analysis of the potential costs and potential benefits to customers.¹²

Authority's views on the benefits analysis

- 3.22. The Authority considers that the separate ownership and management of DN businesses will enable Ofgem to compare and contrast DN performance through the price control review process that occurs every five years. In this respect, the Authority agrees that there is significant evidence from the electricity and water industries that supports the benefits of comparative network regulation. The Authority noted that following the respective privatisation of the electricity distribution networks and the water industry, greater cost reductions have been achieved in these industries than in gas transportation. The benefits of comparative network regulation in the water and electricity industries are considered in Appendix 6 of the Final IA.
- 3.23. The Authority notes that the fact that these benefits have not already been realised for customers through the past and existing price control processes does not represent a failure in the regulatory process. Instead, the Authority considers that these benefits have not been realised due to the information asymmetries associated with regulating a combined ownership structure incorporating transmission and distribution networks under common, as opposed to independent and separate ownership and management.

¹² In quantifying the potential net benefits to customers of the proposed sale of one or more DNs, Ofgem has assumed that the transaction will proceed along the lines announced by NGT. Under the proposed transaction, the Scotland, North of England, South of England and Wales and West networks will be sold to three parties creating three additional comparators.

- 3.24. The Authority therefore considers that approximately 95 percent of the potential benefits to customers associated with the proposed sales transaction are expected to arise from comparative regulation. These benefits should take the form of lower charges for future use of the gas DNs relative to a situation in which all networks would continue to be owned by Transco.
- 3.25. The remaining potential benefits of around 5 percent relate to changes to the regulatory, commercial and operational framework required to support a divested industry structure including the enduring offtake arrangements. As discussed below, the Authority considers that the introduction of market-based offtake arrangements can assist in reducing the potential for inefficient investment and system operation decisions on the part of Transco's NTS and may therefore provide potentially significant benefits to customers. However, it is important to note that it is inherently difficult to measure these benefits when compared to the costs of introducing these arrangements.
- 3.26. The Authority notes that respondents raised a number of concerns regarding the assessment of potential benefits. These are addressed below.

Impact of separation of price control on the benefits analysis

- 3.27. Several respondents commented that many of the benefits claimed to result from the proposed sales transaction would accrue to customers from separate price controls which were introduced from 1 April 2004. These respondents considered that the benefits analysis did not adequately separate the effects of a sale from the effects of price control separation.
- 3.28. Having considered these responses, the Authority does not accept these concerns and considers that the effects of price control separation have been taken into account in the assessment of potential benefits of the proposed sales transaction for customers as presented in the Final IA.
- 3.29. In assessing the potential benefits of the proposed sales transaction in the Final IA, the average rate of improvement in allowed operating expenditure costs for the 'no sale' scenario took into account the effects of price control separation. In constructing the base case 'no sale' scenario, Ofgem assumed a 3% average rate of improvement for DNs in terms of operating expenditure. This rate of improvement is higher than Transco's expected rate of improvement of 2.5% per

annum and is intended to reflect some of the potential benefits of price control separation across the DNs. These potential benefits include increased cost transparency and the ability to make some limited comparisons across business units.

- 3.30. Based upon the experience of regulating the electricity distribution businesses, the Authority considers that it is not the presence of separate price controls, but rather the existence of independently owned comparators, that is the crucial aspect of comparative regulation. Even though each DN now has its own price control, if Transco were to continue to own all of the networks it would not be possible to regulate them on a truly comparative basis as all of the networks would be subject to common ownership and management. In addition, the Authority considers that the experience of the recent electricity distribution price control reviews strongly suggests that the value of information obtained in comparing the performance of businesses under the same management is much more limited than that obtained by comparing the performance of separate management teams competing for advantage within a system of comparative regulation.

Achieving the benefits of comparative regulation

- 3.31. Several respondents commented that customers would incur the costs of DN sales in the near future whilst the benefits were more uncertain and would not be realised for a significant period. In this respect, some respondents have suggested that the benefits to customers from DN sales could instead be achieved without sales and through tighter regulation.
- 3.32. The Authority is mindful that existing customers would be exposed to costs in the short term whilst it is future customers that should ultimately receive the benefits of comparative regulation of the network.
- 3.33. However, the Authority considers that the analysis of the benefits presented in the Final IA was conservative on balance. In agreeing with the assessment of the potential benefits presented in the Final IA the Authority notes that a number of respondents also commented that the benefits analysis was conservative. The Authority therefore considers that it is appropriate for present customers to bear

some costs now to ensure that future customers obtain the benefits of comparative regulation through lower transportation charges.

- 3.34. The Authority considers that in both the water and electricity sectors, the ability of regulators to secure benefits to customers through comparative regulation are proven.
- 3.35. The Authority recognises that the extent to which the benefits of comparative regulation will ultimately be passed through to customers in the form of lower transportation charges will to a large degree be dependent upon Ofgem's ability to effectively regulate the DNs. In this respect, the Authority is committed to establishing an extensive programme of work to ensure that customers receive the benefits of comparative regulation of the DNs in the future.

Treatment of the customer safety net

- 3.36. The Authority notes that some respondents have queried whether compensation would be provided to customers if the benefits associated with the proposed sales transaction were not achieved.
- 3.37. As noted above, the overall case associated with the proposed sales transaction is one of potential net benefits for customers of approximately £225m. As such, the Authority considers that customers' interests will be protected in the event that the proposed sales transaction proceeds in the manner proposed by NGT and that compensation should not therefore need to be paid to customers. Instead, the Authority expects that the comparative regulation process should secure benefits for customers through future DN price control review processes.
- 3.38. The Authority however recognises that NGT may decide to sell only one DN or sell one or more of its DNs to one owner such that only one comparator is created. In this case there is a risk that customers would incur net costs as a result of a DN sale. In order to protect the interests of customers, the Authority is proposing that where only one comparator is created Transco's NTS business would be required to make an ex ante payment to customers in 2007/8. The Authority intends to propose modifications to Transco's GT licence in respect of the NTS to introduce such an obligation.

Authority views on the costs analysis

3.39. The Authority recognises that the proposed sale of DNs would fundamentally change the structure of the gas industry in Great Britain and that this would give rise to costs for some affected parties. The most significant of these changes are:

- ◆ that parties using the GB gas network would need to **interact with multiple network owners** rather than a single network operator as is presently the case.¹³ To a large extent, the Authority considers that the potential for significant costs to arise as a result of multiple interfaces is expected to be mitigated by the proposed creation of an agency that would act as a single interface between network owners and users of the GB network. For example, the agency is intended to ensure that there continues to be a single Supply Point Administration system for customer transfers rather than having each different network owner undertaking this activity separately; and
- ◆ that the sale of DNs would result in a **new external interface** between the NTS and the independently owned DNs which has the potential to create some costs to customers particularly with respect to the introduction and administration of the flexibility product.

3.40. The Authority considers that shippers and suppliers have been extensively consulted on the level of costs that would impact upon their businesses in the event that the proposed sales transaction takes place.¹⁴ The Authority has noted respondents' views that the details of the regulatory, commercial and operational arrangements are still being developed but, having considered the matter, accepts on balance the analysis of the potential costs of DN sales as outlined in the Final IA. The Authority also agrees that the base case estimate for costs is based on conservative assumptions and, indeed, expects that actual costs are likely to be lower.

3.41. For the reasons outlined later in this chapter, the Authority considers that the agency is a key element in the proposed industry framework that should mitigate

¹³ It is however noted that there are already a number of independent gas transporters.

¹⁴ It is noted that the shipper submissions on cost estimates provided to Ofgem in August 2004 accounted for approximately 21 million supply points which equates to over 99 percent of the market. This translates into over 99 percent of the domestic market and 81 percent of the I&C market.

the potential for significant costs to arise as a result of multiple interfaces being created following DN sales. In addition, the Authority considers that whilst the offtake arrangements will impose some administrative costs upon shippers, the arrangements are necessary to protect the interests of customers and should also reduce the potential for customers to incur costs as a result of inefficient investment or system operation decisions.

- 3.42. The Authority has also considered the split of costs between the proposed offtake arrangements and the proposed agency arrangements. The Authority notes in this respect that with respect to the base case cost estimate of £102m, offtake arrangements costs comprise approximately £27m whilst agency related costs comprise £75m.
- 3.43. The Authority has therefore concluded, on this basis, that given the overall balance of potential costs and benefits, the interests of customers would be protected, and indeed promoted, in the event of a DN sale.

Quantification of costs

- 3.44. The Authority notes that many respondents raised concerns over the commercial, regulatory and operational arrangements stating that they were insufficiently developed to be able to make an informed decision on their costs and benefits. In this context, several respondents also commented that the proposed regulatory, commercial and operational arrangements will have significant cost impacts that have been underestimated. However, it is noted that Ofgem did not receive any updated robust cost analysis in the responses to the Final IA.
- 3.45. The Authority recognises that the details of the regulatory, commercial and operational framework are currently in development and that, as such, it is not possible to calculate exactly the costs that shippers could potentially incur associated with the administration of the arrangements, including the proposed NTS offtake flexibility arrangements. Nevertheless, the Authority is satisfied that the arrangements against which shippers provided cost information to Ofgem were sufficiently defined by Ofgem, at the time the shipper surveys were issued, to allow a reasonable cost estimate to be derived.

- 3.46. In addition, the Authority also considers that it is important to emphasise the conservative nature of the cost analysis in the Final IA. It is noted that Ofgem's cost analysis was based on the assumption that the cost figures derived from those submitted by shippers were invariant to the number of supply points. In addition, Ofgem also assumed that the costs calculated would be fully passed through to customers. Whilst Ofgem removed outlier shipper costs from its analysis, some of the costs that were taken into account could be inefficiently incurred such that they would not ordinarily be passed through to customers in a competitive market. As such, the cost estimates are potentially higher than the case may be in practice.
- 3.47. The Authority also wishes to emphasise that, as part of the conditions it is attaching to its consent, it will need to be satisfied that the details of the regulatory, commercial and operational arrangements protect the interests of customers. In this respect, it should be noted that industry participants will have further opportunities to comment upon the development of the detailed regulatory, commercial and operational framework necessary to support a divested industry structure. These comments will inform the Authority's decisions on network code, pricing methodology and licence proposals as well as its decisions on whether its conditions to consent have been met.
- 3.48. Further, it is important to note that if any aspects of the regulatory, commercial and operational arrangements were to result in significant unanticipated costs being imposed it would be open to industry participants to suggest future modifications to these arrangements following any DN sales. Indeed, to the extent that the arrangements are incorporated within the Uniform Network Code, it would be open to shippers to propose modifications to these arrangements. In this respect, it will be important to ensure that the governance arrangements, including the code modification rules that are established within the divested industry structure, are sufficiently flexible to accommodate potential changes.

Authority's conclusions on regulatory, commercial and operational framework

3.49. This section sets out the Authority's conclusions on the regulatory, commercial and operational framework necessary to support a divested industry structure. In addition, it explains why the Authority has endorsed its previous decisions on this framework and has decided that the implementation of enduring offtake arrangements should not now occur until September 2005.

3.50. As noted above, the Authority's decision on the regulatory, commercial and operational framework has been arrived at having due regard to its statutory objective and duties as well as its public law duties. In reaching its decision to grant conditional consent, the Authority has also sought to ensure that the regulatory, commercial and operational arrangements permit each network owner to fulfil its own statutory and licence obligations. These include (without limitation) statutory obligations to:

- ◆ develop and maintain an efficient and economical pipeline system (see section 9(1)(a) of the Gas Act),
- ◆ facilitate competition in the supply of gas (see section 9(1)(A) of the Gas Act); and
- ◆ avoid any undue preference or undue discrimination in the terms on which a gas transporter undertakes the conveyance of gas (see sub-section 9(2)(b) of the Gas Act).

3.51. This section also sets out the Authority's views on the issues raised by respondents regarding the regulatory, commercial and operational framework proposals set out in the Final IA.

Agency and governance arrangements

3.52. The Authority continues to consider that the agency is a key element of the proposed industry framework necessary to protect the interests of customers, as it is expected to mitigate the potential for significant costs to arise as a result of multiple interfaces being created following DN sales. The Gas Forum has

estimated that, in a worst case scenario and in the absence of the agency, the costs created as a result of multiple interfaces could be as large as £730m.

- 3.53. In relation to governance, the Authority continues to believe that the creation of the governance entity should benefit customers by ensuring that UNC and pricing methodology change proposals are managed on an impartial basis.
- 3.54. The Authority has endorsed its decisions on the scope of the agency and the creation of the governance entity as set out in its conclusions document on the agency and governance arrangements.¹⁵

Scope of agency

- 3.55. The Authority notes that some respondents raised concerns regarding the exclusion of metering, connections and site works from the scope of the agency. These respondents commented that the exclusion of these areas of work from the agency has the potential to create complexities.
- 3.56. In its April 2004 RIA on the agency and governance arrangements, Ofgem consulted upon a number of options for the scope of the agency.¹⁶ Having considered the views of respondents, the Authority subsequently outlined in its May 2004 conclusions document that Option C was the most appropriate option to be adopted for the agency and governance arrangements.¹⁷ Under this option, connections, metering and site works arrangements would be excluded from the scope of the agency. It is noted that the May 2004 conclusions document also specified that changes to the scope of the agency should be subject to industry consultation and Ofgem approval. The Authority has now endorsed this position in its decision on whether to consent to the proposed sales transaction.
- 3.57. The Authority would note that in the event that the costs associated with connections, metering and site works were to increase significantly following DN sales, then the decision to exclude these areas from the agency may need to

¹⁵ *National Grid Transco – potential sale of gas distribution network businesses – Agency and governance arrangements*, Ofgem, May 2004.

¹⁶ *National Grid Transco – potential sale of gas distribution network businesses – Agency and governance arrangements, Regulatory Impact Assessment*, Ofgem, April 2004.

¹⁷ *National Grid Transco – potential sale of gas distribution network businesses – Agency and governance arrangements*, Ofgem, May 2004

be reviewed in order to mitigate these costs. The scope of the services and systems to be sub-contracted under the agency arrangements is to be included in UNC. As such, if shippers or other relevant parties remain concerned, following DN sales, that certain additional functions, such as connections, need to be included within the agency then it would be open to them to raise a modification proposal to that effect. Such a proposal would be considered on its merits against the relevant network code objectives and the Authority's wider statutory and public law duties.

- 3.58. However, for the avoidance of doubt, in the event that these services were included within the scope of the agency at a future date, then any costs incurred by gas transporters as a result of this would not be recoverable from customers. The Authority does not consider that it would be appropriate to allow gas transporters to recover these costs from customers as they would arise directly from DN sales and gas transporters already have funding for these services within their existing price control settlements.
- 3.59. The Authority therefore remains of the view that services associated with connections, siteworks and metering should fall outside of the scope of the agency. The Authority considers that keeping these services outside of the agency would promote competition and accountability in their provision. As such, customers should benefit by having a range of service providers from whom to choose for these services which may, in turn, promote quality of service.

Impact of DN sales on metering

- 3.60. The Authority notes that a number of specific concerns were identified relating to the impact that DN sales may have on the quality of metering data as well as the risk that the Review of Gas Metering Arrangements (RGMA) baseline could start to diverge with varied interpretations being adopted by different DNs. Some respondents indicated, in this respect, that Ofgem had underestimated the costs that would be faced by shippers in relation to metering.
- 3.61. Having considered the views of respondents, the Authority agrees with the analysis set out by Ofgem in the Final IA that there are unlikely to be significant costs imposed upon shippers or customers associated with divergences in the

RGMA baseline resulting from independent DN ownership. Indeed, the Authority considers that DNs should be required, through their licences, to become signatories to the Supply Point Administration Agreement (SPAA) which should ensure that integrity of the RGMA baseline is maintained, thus minimising the likelihood of additional systems development costs arising for shippers. In this respect it is noted that standard condition 14 of Transco's current GT licence requires it to be a party to and comply with the relevant provisions of the SPAA. The Authority is minded to retain this condition such that it would be applicable to all gas transporters including DNs.

- 3.62. In addition, the Authority notes that industry agreed RGMA data flows should already facilitate standard information flows to transporters other than Transco. This means a supplier who has invested efficiently in information systems, as a result of RGMA, should not face significant costs to update those metering systems as a result of the creation of new DNs through the DN sale process.
- 3.63. The Authority therefore confirms its previous decision that metering services should fall outside of the scope of the agency arrangements. As noted above, in the event that the costs associated with metering services were to increase significantly in the future then further consideration could be given as to whether the scope of the agency should be broadened to incorporate these services. Without fettering the Authority's discretion, any such proposals would need to carefully assess the costs and benefits to customers including the impact of incorporating metering services within the agency on the quality of service provision.

Allocation of roles and responsibilities

- 3.64. The Authority remains of the view that the allocation of roles and responsibilities set out in the Final IA is appropriate as it creates a clear definition of responsibilities for the network owners and a transparent interface between the NTS and each DN as each network is responsible for its own operational and planning functions. The Authority notes Transco's previous statements that the allocation of responsibilities is in line with current operational practices on the DNs.

- 3.65. The Authority considers that the allocation of responsibilities should promote the economic and efficient operation of each DN. Further, the allocation of roles and responsibilities should better enable the development of commercial services at the NTS/DN interface and should provide signals to network owners to facilitate efficient trade-offs of the costs of operational and capital expenditure within each network, ultimately to the benefit of customers.
- 3.66. The Authority also considers that such a framework would also have the effect of minimising the potential for discrimination to occur, particularly by Transco's NTS business in favour of its retained DNs. This is to be contrasted with the electricity sector where NGC does not have the same incentive to discriminate as it does not own any related distribution businesses. By minimising the potential for Transco to discriminate in favour of its retained DNs, the framework should in turn promote efficient network operation.
- 3.67. The Authority notes that one respondent commented that only minimal gains would be achieved through allowing DNs to manage system operation and that the approach adopted would act as a driving force towards fragmentation as well as being unduly discriminatory.
- 3.68. The Authority does not share this view and considers that by allowing DNs to manage the operation of their own systems, this should protect the interests of existing and future customers by providing benefits through comparative regulation. In addition, the Authority considers that the allocation of roles and responsibilities should provide benefits to customers as accountabilities and functions are clearly defined across the networks.
- 3.69. The Authority also considers that the risks associated with fragmentation, and the creation of multiple interfaces for shippers, have been mitigated through the establishment of appropriate agency arrangements. In particular, there will be a requirement on Transco and each DN, through their respective licences, to become parties to the agency, which in turn would be defined in scope through the UNC. The Authority considers that these are important safeguards that would prevent inefficient fragmentation of interfaces.

Offtake arrangements

- 3.70. The majority of respondents expressed a significant level of concern regarding the introduction of the proposed enduring offtake arrangements. The Authority has noted that several respondents raised specific concerns regarding the costs, and related to this, the complexity, of these arrangements. Further, several respondents also questioned whether the arrangements were justifiable within the context of DN sales with some suggesting that the exit capacity and flexibility proposals should be considered separately to the DN sales project. A number of respondents also indicated that the proposed arrangements could create barriers to entry and have a detrimental impact upon competition. Others raised concerns that the complexity of the arrangements could delay DN sales.
- 3.71. The Authority has noted the significant level of concerns expressed by respondents and has carefully considered whether the proposed arrangements are reasonable and proportionate in light of the Authority's duties. Having considered these matters, the Authority remains of the view that the offtake arrangements, including both the NTS exit capacity and NTS offtake flexibility arrangements are necessary to protect the interests of customers in a divested industry structure and, as such, are reasonable and proportionate requirements.
- 3.72. In view of the concerns expressed by respondents to Ofgem's Final IA consultation regarding the timetable for the introduction of the enduring offtake arrangements the Authority has agreed that the implementation of the enduring NTS exit capacity and NTS offtake flexibility arrangements does not need to occur prior to the completion of the DN sales transaction.
- 3.73. However, whilst the Authority considers that a short delay in the implementation of the enduring offtake arrangements is appropriate, it does not consider that their introduction should be delayed beyond September 2005. The Authority considers that any delay to the introduction of the enduring offtake arrangements beyond September 2005 is against the interests of customers and increases the potential for customers to incur costs as a result of inefficient investment or system operation decisions. As such, the Authority has concluded that in order to protect the interests of customers the enduring offtake arrangements should be implemented by September 2005.

- 3.74. Consistent with this decision, the Authority has imposed conditions to the consent granted to Transco to secure the implementation of the enduring offtake arrangements (which include the enduring NTS exit capacity and NTS offtake flexibility arrangements) on a best endeavours basis by 1 September 2005. These conditions are intended to apply within the period prior to hive down and share sale. In addition, it intends to propose a series of licence obligations on Transco and the DNs to achieve implementation of the enduring offtake arrangements (which include the enduring NTS exit capacity and NTS offtake flexibility arrangements) on a best endeavours basis by 1 September 2005. These conditions are intended to apply in the period following the hive down of the DNs into Transco's four wholly owned subsidiary companies. The conditions and proposed licence obligations are described in detail in paragraphs 3.8 to 3.15 of this chapter.
- 3.75. The Authority agrees that the arrangements will impose some administrative costs upon shippers (estimated by shippers to be in the order of £25 million). However, it considers that the proposed offtake arrangements are necessary to protect customers' interests and are therefore appropriate at this time.
- 3.76. The Authority recognises that aspects of the offtake arrangements, such as the NTS exit capacity regime, have been the subject of reform proposals and industry discussion for a number of years. As part of these discussions, Ofgem has sought to develop non-discriminatory price-based arrangements that provide investment signals to Transco to allow it to efficiently trade off the costs of interruption with the costs of investment. In the light of DN sales, the Authority considers that it has become even more important to reform these arrangements such that they protect the interests of customers in a divested industry structure.
- 3.77. In this respect, it is particularly important to ensure that there are non-discriminatory and price-based arrangements for access to capacity and flexibility given that both DNs and shippers securing capacity on behalf of NTS direct connects (NTS direct connect shippers) will be competing to secure this capacity under a divested industry structure.
- 3.78. In the absence of non-discriminatory arrangements, the Authority considers that capacity may not be allocated to those that value it the most in the short term. As a consequence, competition between existing participants, namely DNs and

NTS direct connect shippers could be distorted and incumbents may be favoured over new entrants thereby potentially raising barriers to entry. Further, unduly discriminatory arrangements for long term pipeline access may prevent the establishment of efficient pricing signals for capacity and flexibility.

- 3.79. The Authority notes that the proposed offtake arrangements have been opposed by most respondents to the consultation. However, the Authority considers that incumbents are generally unlikely to perceive that there will be benefits associated with a regime which requires them to compete with potential new entrants for capacity that was previously guaranteed to them. In this respect, it is important that all market participants including incumbents and future new entrants can access capacity on a non-discriminatory basis.
- 3.80. In the following sections, the Authority responds to some of the specific comments raised by respondents on aspects of the offtake arrangements.

Ex ante vs Ex post regulation

- 3.81. The Authority notes that several respondents commented that the arrangements have been proposed by Ofgem because it has concerns regarding the risk of undue discrimination. These respondents commented that concerns of this nature could be addressed through licence obligations (ex post regulation) rather than changes to commercial arrangements (ex ante regulation).
- 3.82. One respondent indicated that it would be content with the adoption of administered offtake arrangements and considered that, combined with information transparency, normal regulatory oversight of monopoly activities and robust internal separation, it would offer the lowest cost solution.
- 3.83. Having considered respondents' views, the Authority considers that, where possible, it is preferable to rely on ex ante market-based arrangements for the allocation of network products such as capacity and flexibility. In particular, the Authority considers that these arrangements are more transparent and provide more certainty to market participants relative to ex post licence enforcement which is reliant upon the regulatory interpretation of rules to specific cases.
- 3.84. The Authority considers that a market-based approach may also lead to more efficient outcomes for customers than a rule based regulatory approach. For

example, where scarce capacity is allocated on the basis of a first come first serve as opposed to a price-based approach, those that value the capacity the most may be denied network access.

- 3.85. There are also significant regulatory costs associated with ex post regulation approaches. In particular, such approaches are likely to increase the risk of disputes occurring between the NTS, DN businesses and NTS direct connect shippers in relation to the amount of capacity that should be allocated.
- 3.86. In addition, a price-based approach to the allocation of capacity is particularly important in the context of DN sales in order to minimise the risk that Transco's NTS business may discriminate in favour of its retained DN businesses.
- 3.87. Further, under an ex post regulation approach, information asymmetries make it difficult for the regulator to determine whether a gas transporter has discriminated in an undue manner. As such, increased regulatory resources are likely to be required in monitoring all aspects of the gas transporters conduct in operating their network businesses. In this context, the Authority considers that an ex ante price-based approach to regulation is more light handed and is therefore consistent with the principles of better regulation.
- 3.88. In the event that an investigation was undertaken into the conduct of Transco, or any other gas transporter, in response to discrimination concerns under an ex post regulation regime, such a process would be likely to take a considerable period of time. The Authority considers that whilst such an investigation is in process the underlying conduct may continue thereby distorting competition and further increasing the potential costs to customers associated with an ex post regime.
- 3.89. The Authority nevertheless recognises that, even with the presence of efficient market arrangements, it is necessary to rely upon the statutory and licence obligations of gas transporters as an important regulatory backstop.

Legal separation – comparison with the offtake arrangements

- 3.90. One respondent commented that it was disappointing that Ofgem did not consider it could simply rely upon licence conditions to prevent undue discrimination in the offtake arrangements, particularly in view of the licence

conditions that the Authority intends to propose to replicate the effect of legal separation between Transco's retained DNs and NTS.

- 3.91. In the Authority's view the offtake arrangements and business separation regime are both important, complementary elements of a package of proposals that are designed to ensure no undue discrimination particularly as between Transco's NTS and retained DN businesses. Further, having carefully explored the implementation issues associated with legal separation, the Authority is not satisfied that the costs of requiring legal separation justify the benefits.
- 3.92. In this respect, the Authority considers that it is not appropriate to require Transco to hive-down the NTS into a separate legal entity. The Authority considers that were the NTS to be hived down there are material risks that this would have a serious detrimental impact upon wholesale competition with significant cost exposure to customers. In particular, there would be risks that third party contracts (including gas supply contracts) that reference Transco's network code might need to be readjusted or renegotiated. The Authority considers that this may undermine confidence in the wholesale gas market with significant impacts upon customers.
- 3.93. In addition, the Authority does not consider that it would be proportionate to require Transco to hive-down its retained DNs given the significant costs that would be imposed on Transco associated with the transfer of assets to a separate entity and the associated restructuring of Transco debt that would be required. In particular, as the retained DNs comprise a significantly larger proportion of Transco plc's business than the NTS, an effect of requiring the retained DNs to be hived out of Transco plc would be to trigger bond holder covenants of existing Transco debt. This would impose significant debt restructuring costs on Transco.
- 3.94. These potential costs are outlined in more detail in Appendix 15 of the Final IA. Given these costs, the Authority considers that it is more appropriate to seek to retain the benefits of legal separation through a package of licence conditions designed to replicate the effects of legal separation. These licence conditions relate to:

- ◆ corporate governance;

- ◆ enforceable undertakings between Transco's NTS and retained DN businesses; and
- ◆ regulatory accounting provisions.

3.95. It is noted that whilst the Authority will not be requiring the legal separation of the Transco NTS and retained DN businesses, it however intends to introduce targeted structural separation. In particular, the Authority intends to propose licence conditions that impose requirements relating to physical, information and operational separation between Transco's NTS and retained DN businesses.

Costs of offtake arrangements

- 3.96. One respondent to the Final IA considered that the majority of the costs of DN sales are likely to arise from the offtake arrangements, whereas on the basis of the Final IA, these arrangements would only produce 5% of the benefits. The respondent therefore suggested that the offtake arrangements proposals should not be pursued.
- 3.97. Having considered respondents' views, the Authority does not accept that the majority of costs will arise from the offtake arrangements. As noted above, the costs associated with the offtake arrangements are approximately £27m whereas the costs associated with the introduction of the agency arrangements are approximately £75m.
- 3.98. In addition, the Authority considers that the costs associated with the introduction of the offtake arrangements may be overstated to the extent that the enduring and non-discriminatory offtake arrangements would, in any event, have needed to be introduced at some point in the future.
- 3.99. Whilst the Authority recognises that a smaller proportion of the benefits are derived from the proposed offtake arrangements relative to the benefits of comparative regulation, it is important to note that it is inherently difficult to measure the benefits of introducing market-based arrangements compared to their costs.
- 3.100. In this respect, the Authority considers that the introduction of market-based arrangements should assist in reducing the potential for inefficient investment and system operation decisions on the part of Transco's NTS, thereby reducing

costs for customers. In particular, long term market-based signals for capacity should assist in reducing the risks of stranded investments, the costs of which may be borne by customers. In the short term, market-based offtake arrangements should reduce the potential for customers to incur costs associated with any inefficient system operation actions taken to manage network constraints and congestion.

3.101. In addition, in the extreme, discriminatory non-market-based arrangements for the allocation of NTS capacity and flexibility in the gas sector may also have serious security of supply and cost implications on the electricity transmission network. For example, it is possible that a decision taken by Transco's NTS to discriminate in the provision of exit capacity or flexibility may prevent a generator from securing access to the gas network and bidding into the electricity balancing mechanism. This could, in turn, create security of supply risks on the electricity network and costs for electricity customers. The Authority notes, in this respect, that the availability of gas fired generation plants is a key concern that is frequently raised by National Grid Company (NGC) in its Winter Operations reports.

Treatment of NTS and DN customers

3.102. The Authority notes the concerns raised by some respondents that the introduction of the offtake arrangements would result in different regimes applying to NTS and DN customers. In particular, some respondents raised concerns that a harsher regime would apply to NTS customers relative to DN customers.

3.103. Having considered respondents' views, the Authority does not accept this argument. In reaching this decision, the Authority has recognised that there are different characteristics across the NTS and DNs which justify the consideration of different commercial approaches to offtake arrangements.

3.104. In addition, as part of the development of the offtake arrangements, one of the options considered was the creation of capacity booking arrangements that would apply across both the DNs and the NTS such that an equivalent regime would apply to all networks. However, the Authority notes that it was decided

that a different offtake regime should apply to the NTS as compared to the DNs. This was done in response to concerns raised by respondents.

Impact of offtake arrangements on DNs and NTS direct connects

- 3.105. The Authority notes that some respondents raised concerns that the operation of the offtake arrangements would benefit DNs over NTS direct connects. In particular, respondents commented that DNs do not face the same degree of uncertainty and have the option to avoid purchasing capacity and flexibility products by investing in their own networks whilst NTS direct connects do not have the ability to do this and would need to modify their behaviour.
- 3.106. Having considered the issue raised, the Authority does not accept this concern. Whilst it recognises that, at the margin, a DN has the ability to invest in its own network to offset its capacity requirements, the DN will nevertheless, as with an NTS direct connect shipper, need to secure NTS exit capacity to satisfy its demand. Further, it is important to emphasise that under the flexibility arrangements that have been proposed, shippers acting on behalf of NTS direct connects will be able to access NTS offtake flexibility by purchasing it either from Transco or on the secondary market. In the absence of these arrangements, shippers acting on behalf of NTS direct connects may not be able to secure access to such flexibility to the extent that it is allocated wholly to the DNs.
- 3.107. The Authority also notes that one route to address this concern would have been to pursue the creation of a shipper-led booking model. Under this model, shippers conveying gas to customers on the DNs, rather than the DNs themselves, would be responsible for securing NTS exit capacity. However, a shipper-led booking model was rejected, in response to concerns raised by industry participants, following Ofgem's June 2004 Offtake Arrangements consultation in favour of a booking model that had less impact upon shippers but which still provided for a non-discriminatory approach.¹⁸
- 3.108. In addition, the Authority notes that each DN will have incentives placed upon it to ensure that it efficiently procures capacity from the NTS and does not inefficiently overbook capacity on the NTS in order to avoid having to build

¹⁸ See *National Grid Transco – Potential sale of gas distribution network businesses, Offtake arrangements*,

capacity on its own networks. This should assist in ensuring that DNs are not unfairly advantaged by the proposed offtake arrangements.

EU gas regulation

- 3.109. One respondent indicated that there are a number of elements of proposed EU legislation that the offtake and interruptions arrangements do not adequately address. The respondent stated that whilst Ofgem has previously provided its views on these issues it does not agree with the interpretation of the legislation that was provided and believes that the arrangements may be challenged. The respondent specifically raised concerns that the provision of use-it-or-lose-it interruptible capacity as an anti-hoarding product would not constitute an interruptible service within the meaning of the EU legislation.
- 3.110. The Authority notes that its views on the draft European Gas Regulation (the draft regulation) on conditions for access to gas transmission networks have been set out in detail in paragraphs 5.39 to 5.48 of its August 2004 conclusions document on the proposed Interruptions arrangements.¹⁹ The Authority notes that whilst changes have been made to the draft regulation since the publication of the August document, it continues to consider that the conclusions reached remain valid.
- 3.111. In response to the specific concern raised regarding the provision of interruptible capacity, the Authority notes that Article 4 of the draft regulation specifies that transmission system operators shall provide both firm and interruptible third party access services and that interruptible transportation services shall reflect the probability of interruption. The Authority considers that where Transco enters into demand side contracts to buy-back capacity from NTS direct connect shippers and DNs to manage congestion then it is effectively discharging its obligations under draft Article 4.2, particularly as the prices of these contracts would reflect the probability of interruption.
- 3.112. Whilst the nature of the interruptible product to be released by Transco's NTS is currently being developed through Transco's consultation on its business rules

Conclusions document on framework, Ofgem, August 2004.

¹⁹ *National Grid Transco – Potential sale of gas distribution network businesses, Interruptions arrangements – Conclusions document on framework, Ofgem, August 2004.*

for the exit capacity arrangements, the Authority considers that the release of a use-it-or-lose-it interruptible product on or close to the gas day may also constitute an additional interruptible service and would not in any event be inconsistent with the provision of interruptible services. The Authority will keep under review compliance with the requirements of the draft Regulation as the products are being developed.

- 3.113. The Authority considers that elements of the draft regulation are very supportive of the proposed offtake arrangements. In particular, it is noted that the draft regulation specifies the importance of introducing non-discriminatory arrangements for the provision of transmission services. It also requires transmission system operators to implement non-discriminatory and transparent capacity allocation mechanisms that provide appropriate economic signals for efficient use of capacity and facilitate investment in new infrastructure.
- 3.114. The Authority also considers that given the proposed introduction of the draft regulation it is likely that non-discriminatory NTS exit capacity arrangements would need to be introduced at some point in the future irrespective of DN sales. As a result, the Authority considers that the cost estimates associated with DN sales are potentially more conservative than they may otherwise be on the basis that the arrangements would be required in any event.

Exit capacity arrangements

- 3.115. The Authority notes the significant level of concerns expressed by respondents regarding the exit capacity arrangements and has specifically considered whether the proposed arrangements are reasonable and proportionate in the light of the Authority's duties. Having considered these matters, the Authority remains of the view that the NTS exit capacity arrangements are necessary to support a divested industry structure and are reasonable and proportionate requirements.
- 3.116. In view of the concerns expressed by respondents to the Final IA regarding the timetable for the introduction of the enduring offtake arrangements the Authority has agreed that the implementation of the enduring NTS exit capacity arrangements does not need to occur prior to the completion of the DN sales transaction.

- 3.117. However, whilst the Authority considers that a short delay in the implementation of the enduring NTS exit capacity arrangements is appropriate, it does not consider that their introduction should be delayed beyond September 2005. The Authority considers that any delay to the introduction of the enduring NTS exit capacity arrangements beyond September 2005 would be against the interests of customers and would increase the potential for customers to incur costs as a result of inefficient investment or system operation decisions. As such, the Authority has concluded that, in order to protect the interests of customers, the enduring NTS exit capacity arrangements should be implemented by September 2005 on a best endeavours basis.
- 3.118. Consistent with this decision, the Authority has imposed conditions to the consent granted to Transco to secure the implementation of enduring offtake arrangements, including the enduring NTS exit capacity arrangements, on a best endeavours basis by 1 September 2005. These conditions are intended to apply within the period prior to hive down and share sale. In addition, it intends to propose a series of licence obligations on Transco and the DNs to achieve implementation of the enduring offtake arrangements (which include the enduring NTS exit capacity arrangements) on a best endeavours basis by 1 September 2005. These conditions are intended to apply in the period following the hive down of the DNs into Transco's four wholly owned subsidiary companies. The conditions and proposed licence obligations are described in detail in paragraphs 3.8 to 3.15 of this chapter.
- 3.119. In terms of NTS exit capacity, the Authority consider that it is important to ensure that users of the NTS, including both incumbent participants and new entrants, are treated on an equal and non-discriminatory basis and that efficient investment signals of the value of capacity can be generated. This should ultimately create benefits for customers.
- 3.120. Under the long term arrangements, users of the NTS, including DNs and shippers shipping to direct connects, would be able to gain access to the network on a non-discriminatory basis at a regulated price. The Authority considers that this should ensure that the NTS receives valuable investment signals. In the short term, the arrangements would ensure that where capacity on the network is scarce, it is provided to those that value it the most.

- 3.121. The Authority does not consider that the arrangements will impose significant burdens upon shippers. Indeed, the arrangements are similar in nature to the entry capacity arrangements and therefore constitute an allocation mechanism that is familiar to most shippers.
- 3.122. Further, the extent to which individual shippers incur costs under the arrangements will be dependent upon how they wish to manage their NTS exit capacity portfolio. Some shippers may elect to secure all of their NTS exit capacity on a long term basis and therefore not incur costs associated with trading capacity in the short term. Others may however, elect to take a greater role in the trading of capacity and therefore incur costs if it is profitable for them to do so.
- 3.123. In this section, the Authority considers a number of comments raised by respondents that relate specifically to the proposed exit capacity arrangements.

Booking of long-term exit capacity

- 3.124. The Authority notes that a number of respondents questioned whether any shippers would secure NTS exit capacity on a long term basis and hence were sceptical as to whether any long term investment signals would be generated. Others commented that it would be difficult for customers to determine their longer term capacity requirements.
- 3.125. Having considered respondents' views on this issue the Authority has concluded that it does not agree with the points raised. The Authority notes that it will be up to individual shippers and DNs to determine whether they wish to secure capacity on a long term basis. However, the Authority considers that there may be incentives on some shippers and DNs to book long term. In particular, by booking longer term, shippers and DNs will be able to obtain NTS exit capacity at a regulated price and will therefore be able to avoid the risk that they will have to pay a higher price in short term capacity allocations in the event that there is insufficient capacity available.
- 3.126. In addition, by booking longer term, shippers and DNs will be able to send investment signals to Transco. This, in turn, should benefit customers in the form of efficient investment. The arrangements should also reduce the risk to Transco, and potentially to customers, of stranded assets or investment.

3.127. As noted above, the Authority considers that the exit capacity booking arrangements should also promote competition between shippers. In particular, those shippers with the most efficient or best capacity booking strategy for their existing and future customer portfolios should perform better relative to their competitors in the shipping sector.

FSA rules

3.128. A number of shippers commented that the financial services legislation enforced by the Financial Services Authority (FSA) would prevent them from advising customers on their capacity requirements.

3.129. Although Ofgem works closely with the FSA on issues of mutual regulatory interest, the Authority clearly has no remit to consider such issues relating to compliance with the financial services legislation. The Authority therefore considers that it is the responsibility of shippers to determine and take a view as to their own compliance with financial services legislation. Nevertheless, the Authority has considered the issue that has been raised. In this respect, the Authority considers that it is not clear why a shipper would be seen to be giving advice to a user in respect of NTS exit capacity when it is the shipper that is responsible for security the capacity rights itself, rather than the end user.

Flexibility arrangements

3.130. The Authority has noted the significant level of concerns expressed by respondents regarding the NTS offtake flexibility arrangements and has specifically considered whether the proposed arrangements are reasonable and proportionate in the light of the Authority's duties. Having considered these matters, the Authority remains of the view that the enduring NTS offtake flexibility arrangements are necessary to protect the interests of customers in a divested industry structure and are reasonable and proportionate requirements.

3.131. In view of the concerns expressed by respondents to the Final IA regarding the timetable for the introduction of the enduring offtake arrangements, the Authority has agreed that the implementation of the enduring NTS offtake flexibility arrangements does not need to occur prior to the completion of the sales transaction.

- 3.132. However, whilst the Authority considers that a short delay in the implementation of the enduring NTS offtake flexibility arrangements is appropriate, it does not consider that their introduction should be delayed beyond September 2005. The Authority considers that any delay to the introduction of the enduring NTS offtake flexibility arrangements beyond September 2005 is against the interests of customers and increases the potential for customers to incur costs as a result of inefficient investment or system operation decisions. As such, the Authority has concluded that, in order to protect the interests of customers, the enduring NTS offtake flexibility arrangements should be implemented by September 2005 on a best endeavours basis.
- 3.133. Consistent with this decision, the Authority has imposed conditions to the consent granted to Transco to secure the implementation of enduring offtake arrangements, including the NTS offtake flexibility arrangements, on a best endeavours basis by 1 September 2005. These conditions are intended to apply within the period prior to hive down and share sale. In addition, it intends to propose a series of licence obligations on Transco and the DNs to achieve implementation of the enduring offtake arrangements (which include the enduring NTS offtake flexibility arrangements) on a best endeavours basis by 1 September 2005. These conditions are intended to apply in the period following the hive down of the DNs into Transco's four wholly owned subsidiary companies. The conditions and proposed licence obligations are described in detail in paragraphs 3.8 to 3.15 of this chapter.
- 3.134. In the light of DN sales, the Authority considers that it is particularly important to ensure that there are non-discriminatory and price-based arrangements for access to NTS offtake flexibility given that both DNs and NTS direct connect shippers will be competing to secure these rights under a divested industry structure.
- 3.135. Under the long term arrangements, users of the NTS, including DNs and shippers shipping to direct connects, would be able to obtain flexibility on a non-discriminatory basis at a regulated price. The Authority also considers that this should ensure that Transco's NTS receives valuable investment signals. In the short term, the arrangements would ensure that where flexibility on the network is scarce, they efficiently allocate the flexibility rights to those that value it the most.

- 3.136. The Authority recognises that the introduction of the flexibility product represents a new development for shippers. Whilst meters already exist to monitor flexibility usage, for the first time shippers will actively need to consider their flexibility requirements where it has not previously been necessary for them to do so.
- 3.137. A number of respondents raised specific concerns regarding the proposed flexibility arrangements. These concerns are considered below.

Impact of flexibility product on storage

- 3.138. A number of respondents commented that the flexibility arrangements would have negative impacts upon investment in, and the use of, gas storage facilities. The Authority does not consider that the proposed flexibility product will adversely disadvantage storage facilities. To the extent that storage users wish to use within day system flexibility in injecting gas into their facilities they would be required to secure flexibility rights. Over the long term, the cost reflective pricing of this product will incentivise users of the network to utilise the network on an efficient basis. This applies equally to NTS direct connect shippers utilising storage facilities as it does to DNs. Therefore, any impact on storage should better reflect the costs these parties impose on the network than is currently the case.
- 3.139. In addition, given that most storage operators offtake gas from the NTS at off-peak times of the year to fill their storage facilities, the users of these facilities should be able to secure their requirements at prices reflecting its likely plentiful availability at that time. As such, storage users would avoid the relatively high cost of securing flexibility rights that span peak periods. On this basis the Authority is not convinced that the flexibility product will have a significant impact upon storage use or investment.

Impact of flexibility arrangements on electricity sector

- 3.140. Some respondents commented that the flexibility product would hinder the efficient operation of the wholesale electricity market. In this respect, one respondent noted that the arrangements may limit the extent to which gas fired generators participate in the electricity balancing mechanism.

- 3.141. The Authority has carefully considered the gas and electricity interactions associated with the introduction of the NTS flexibility arrangements. The Authority notes that NGT has informed Ofgem and members of the Development and Implementation Steering Group (DISG) that when flexibility on the NTS is scarce it tends to discriminate in favour of NTS direct connects over its DNs.²⁰ In a situation where NGT does not own some of the DNs it would not be appropriate for such discrimination to occur. As such, the Authority considers that it is important that non-discriminatory arrangements can be established that would ensure, in the event of a DN sale, that NTS direct connects can access this flexibility which may be critical to facilitating security of supply on the electricity network, for the reasons outlined below.
- 3.142. The Authority considers that the proposed NTS offtake flexibility arrangements should have a positive effect on facilitating the efficient operation of short term power markets. Under the proposed arrangements, all power stations with NTS connections would, through their shipper, be able to access NTS offtake flexibility on a non-discriminatory and equal basis, either in the short term or long term. This should ensure that gas fired power stations connected to the NTS can, where they wish to, ensure that they have the necessary firm access to the gas network to be able to offer firm generation to NGC as electricity system operator where it is needed to balance the electricity system.
- 3.143. The Authority considers that these arrangements would facilitate competition between shippers competing to provide capacity and flexibility to generators on an efficient basis that most closely meets their requirements. Further, the arrangements should facilitate competition between gas fired generators in the provision of services to both their customers and to NGC as electricity system balancer.²¹ This in turn should assist NGC in operating an efficient electricity

²⁰ See DISG 31 (4 January 2005) meeting minutes. These are available on Ofgem's website at www.ofgem.gov.uk

²¹ It is noted here that the flexibility arrangements should expose generators to the costs that they impose on the gas system in respect of their use of flexibility. The Authority considers that this will facilitate generation competition in the electricity sector. Under the existing electricity arrangements gas fired generators do not need to reflect the costs associated with their use of gas system flexibility in the prices that they offer to NGC for balancing services. By contrast, a coal plant is exposed to its own costs of providing flexible services and reflects these costs in their prices. The Authority considers that by effectively targeting the cost of using gas system flexibility on generators, this should ensure that competition in the electricity generation sector is improved.

system and in maintaining security of supply on the electricity transmission network.

Unbundling of exit capacity from flexibility

- 3.144. A number of respondents indicated that they were unsure how NTS exit capacity could be unbundled from NTS offtake flexibility, on the basis that exit capacity is inherently linked to system flexibility.
- 3.145. Having considered respondents' views, the Authority considers that it is important that NTS flexibility is unbundled from NTS exit capacity and released as a separate product.
- 3.146. The Authority considers that the release of the flexibility product may benefit customers to the extent that flow flexibility can be used to offset costly investment on the DNs. Therefore, without the release of the flexibility product and the investment signals that it provides there would be a risk that Transco may over-invest in its network thereby creating stranded assets.
- 3.147. Further, there is a risk that following DN sales, individual DNs may increase the extent to which they profile flows of gas from the NTS. This is likely to lead to Transco having to take balancing actions. The Authority considers that the introduction of the flexibility product should assist in ensuring that the costs of Transco balancing actions are appropriately targeted to the DNs that are causing them.
- 3.148. It is noted, in this context, that Transco has indicated that the introduction of the NTS flexibility product will provide it with information for planning and the development of the transmission system. Further, Transco has indicated that the flexibility product will allow parties to indicate their within day requirements.²²
- 3.149. For the reasons outlined above, the Authority considers that having a bundled NTS exit capacity product may give rise to costs to customers in both the short and the long term associated with inefficient investment and inefficient operation of the NTS.

²² *Flow Flexibility – Overview*, Transco presentation to DISG 24, 4/11/04.
NGT sale of gas distribution networks – Authority decision document
Office of Gas and Electricity Markets

Business separation

- 3.150. A number of respondents indicated that they were not content with the reasons for the Authority's change of position regarding the requirement on Transco to legally separate its NTS from its retained DN businesses.
- 3.151. The Authority notes that the reasons underlying the decision not to require Transco to legally separate its NTS from its retained DNs have been set out in Appendix 15 of the Final IA published in November 2004.²³
- 3.152. The Authority has however considered this issue in the light of respondents' views and agrees with the analysis contained in Appendix 15 of the Final IA that it is not appropriate to require Transco to hive-down the NTS into a separate legal entity. The Authority agrees, in this respect, that there are material risks that this would have a serious detrimental impact upon wholesale competition with significant cost exposure to customers.
- 3.153. Further, for the reasons outlined in Appendix 15 of the Final IA, and as discussed above, the Authority does not consider that it would be proportionate to require Transco to hive-down its retained DNs given the significant costs that would be imposed on it in relation to the transfer of assets to a separate entity and the associated restructuring of Transco debt that would be required.

Security of supply

- 3.154. Some respondents raised concerns that the creation of independently owned DNs could have impacts upon security of supply. One commented that establishing incentives on DNs not to overbook NTS capacity may create security of supply risks.
- 3.155. The Authority has carefully considered the security of supply implications associated with the potential sale of one or more DNs.

²³ *National Grid Transco – Potential sale of gas distribution network businesses, Final Impact Assessment – Appendices*, Ofgem, November 2004.
NGT sale of gas distribution networks – Authority decision document
Office of Gas and Electricity Markets

- 3.156. The Authority considers that the allocation of roles and responsibilities to network owners as set out in the Final IA should assist in ensuring security of supply on the gas network by ensuring that accountabilities are clearly defined.
- 3.157. The Authority notes that Transco has prepared a paper setting out its views regarding the impact of DN sales on security of supply issues.²⁴ Transco concluded in this paper that system security would be maintained following the DN sales process and that, as such, the sales process would not adversely affect the safety of the wider system. The paper stated that the Health and Safety Executive (HSE) would need to be satisfied on this latter point before it provides its consent to a sale by accepting the associated safety cases.
- 3.158. The Authority considers that it is particularly important that the arrangements established at the NTS interface protect customers' interests by ensuring the maintenance of security of supply in both the long term and the short term. It is also necessary to give consideration to the impact of the proposed commercial, operational and regulatory framework on security of supply in the electricity sector.
- 3.159. In the long term, the Authority considers that the offtake arrangements should facilitate efficient investment in the NTS by providing signals to Transco regarding users' capacity and flexibility requirements. In the short term, the proposed arrangements should ensure that Transco, as NTS operator, has a broad range of options available to it through which it can manage constraints and congestion on its system in an efficient manner to ensure security of supply is maintained. For example, the proposed commercially based interruption arrangements should provide Transco with a broad range of choice in which to enter into system management contracts.
- 3.160. Further, as discussed above, the Authority considers that the proposed arrangements for NTS exit capacity and NTS offtake flexibility should also facilitate security of supply on NGC's transmission system, by ensuring that all NTS direct connects, including gas fired generators, can access flexibility on the

²⁴ The Transco paper was presented to the Development and Implementation Steering group and can be accessed on the Ofgem website at www.ofgem.gov.uk
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NTS at times when they need to be able to offer generation services back to NGC.

- 3.161. As outlined above, one respondent has raised a concern that security of supply risks may result from incentives on DNs not to overbook capacity. The Authority does not accept this concern and notes that the proposed DN incentive is to ensure that its bookings are aligned with its security of supply obligations, including its 1 in 20 planning obligation which is to be included in the DN licences. In this respect, the incentive should ensure that DN bookings do not lead to costly over investment in the NTS at significant cost to customers.

Process concerns

- 3.162. A number of respondents raised concerns regarding the processes associated with Ofgem's consultation on DN sales and with the development of the proposed regulatory, commercial, and operational framework. These concerns are addressed in the following section.

Timetable for reform

- 3.163. Several respondents raised concerns regarding the timetable for reform, and the resulting high regulatory workload and short consultation periods for considering potential changes to the regulatory, commercial and operational framework.
- 3.164. The Authority recognises that the timetable associated with the development of changes to the commercial, regulatory and operational framework is one that involves the development and implementation of a significant degree of industry change over a short time period. However, it is important to note that it is a timetable that is driven by Transco's own commercial transaction for the sale of its DNs.
- 3.165. Nevertheless, in view of the concerns raised with the timetable the Authority has decided that the enduring NTS exit capacity and NTS offtake flexibility arrangements do not need to be implemented prior to the completion of the proposed DN sales transaction. However, whilst the Authority considers that a short delay in the implementation of these arrangements is appropriate, it does not consider that introduction of the arrangements should be delayed beyond September 2005.

- 3.166. In particular, the Authority considers that the changes to the regulatory, commercial and operational framework, including the enduring offtake arrangements, are necessary to ensure that customers are protected within a divested industry structure and that they are able to secure all of the considerable benefits associated with a sale.
- 3.167. The Authority also considers that were there to be significant delays to the DN sales timetable this would create a risk that Transco or the buyers would withdraw from the transaction and that all of the potential benefits to customers would be lost.
- 3.168. As noted above, the Authority has taken account of the impacts upon shippers of the introduction of enduring offtake arrangements and has delayed the introduction of these arrangements to September 2005. In addition, it is noted that the proposed enduring arrangements for NTS exit capacity and flexibility will not come into effect until 2008 although allocations of these products will commence in 2005. The Authority considers that the operation of interim capacity and flexibility arrangements in the intervening period from 2005 to 2008 should provide some additional time for shippers to adjust to the new enduring arrangements.

Process for developing offtake arrangements

- 3.169. Several respondents raised concerns that discussions on the development of the UNC and the proposed changes to the exit regime are being undertaken outside of established network code modification processes and that the process adopted by Transco has no formal standing. Concerns were also raised that commitments made by the Authority in previous documents regarding how changes to the exit regime would be progressed have been disregarded.
- 3.170. The Authority considers that the method by which Transco is consulting on changes to the exit arrangements is necessary in order to reflect the creation of a multi-transporter UNC that would support a potential divested industry structure. In this respect, the Authority does not consider that a multi-transporter UNC can be achieved through the modification process to Transco's existing network code. This is because the UNC will also be referenced in the proposed short form codes of the new DN owners which fall outside the scope of Transco's

present network code. In this respect, it is important to recognise that Transco has sought to establish an inclusive consultation process that replicates, where possible, the present network code consultation process and enables consultation on the full UNC arrangements with all interested parties.

- 3.171. Further, the Authority does not believe that the Transco approach undermines any commitments made by the Authority. In its August 2004 conclusions documents on the Offtake Arrangements²⁵ and the Interruptions Arrangements²⁶, the Authority indicated that the development of the regulatory, commercial, and operational framework would be progressed through a combination of licence modification proposals, pricing consultations, and network code modification proposals. The Authority considers that the NGT approach does not depart from this statement as it recognises that there will need to be modifications to Transco's existing network code to allow it to incorporate, by reference, the UNC.
- 3.172. The Authority also notes that Ofgem will be issuing its own formal consultation on the UNC arrangements in March 2005. This consultation will be undertaken in parallel to the consultation that Transco will carry out on its own modification proposal to create a short form code from its present network code. It is proposed that the short form code would reference the UNC.
- 3.173. Interested parties will therefore have several opportunities to comment on the changes that are proposed in relation to both the legal text of the UNC and its interactions with the proposed licence arrangements through the Transco network code modification process as well as Ofgem's own March 2005 consultation on the UNC legal text.
- 3.174. It is also important to note that, as part of the conditions to its consent, the Authority will need to be satisfied that, amongst other things, appropriate code arrangements are in place before hive down can occur. The consultations that will be undertaken through the Transco network code process as well as Ofgem's March 2005 UNC consultation will assist in informing the Authority as

²⁵ *National Grid Transco – Potential sale of gas distribution network businesses, Offtake arrangements, Conclusions document on framework*, Ofgem, August 2004.

²⁶ *National Grid Transco – Potential sale of gas distribution network businesses, Interruptions arrangements, Conclusions document on framework*, Ofgem, August 2004.

to whether these conditions have been met. A further discussion of the conditions to consent appears in chapter 4.

Progress in development of regulatory, commercial, and operational arrangements

- 3.175. A number of respondents raised concerns that significant detail on the regulatory, commercial, and operational arrangements remains to be developed with one respondent stating that much information will not be available to the Authority in making its decision.
- 3.176. The Authority recognises that the final details of the proposed regulatory, commercial and operational framework are yet to be resolved and had not been resolved at the time of its January 2005 meeting. In this respect, it has taken its decision on whether to consent to Transco's request to dispose of DN assets on the basis of the high level arrangements set out for the regulatory, commercial and operational framework within the Final IA. However, given that the details of the framework are not as yet finalised, the Authority has decided that it would be appropriate to specify conditions to its consent that would need to be met before Transco is able to hive-down its DN assets into four wholly owned subsidiary companies and before it is able to sell the shares in these companies to third party purchasers.
- 3.177. These conditions, which are discussed in more detail in chapter 4, provide that the Authority would need to be satisfied that the necessary licence and UNC arrangements are in place across Transco's NTS and the DN businesses before the hive-down and share sales can go ahead.
- 3.178. Before these conditions are met, there will need to be a considerable degree of further consultation on the proposed licence modifications, as well as the network code arrangements. As noted above, as part of this process, Ofgem will be issuing its own consultation on the UNC arrangements in March 2005. Further, Ofgem will be issuing licence changes for consultation in February 2005 as part of the section 8AA licence transfer process under the Gas Act and the associated section 23 consultation with respect to the licence of the retained DNs. Further, a series of licence modification proposals covering, amongst other things, the incentive arrangements for the NTS and the DNs will be issued

in May 2005 following the proposed date of hive down and in advance of the share sale. A more detailed timetable for these consultations appears in Chapter 4.

- 3.179. As such, the Authority considers that industry participants will have further opportunities to provide comments on the details of the proposed regulatory, commercial, and operational framework.

Role of the Development and Implementation Steering Group

- 3.180. A number of respondents commented that decisions on the regulatory, commercial and operational framework for DN sales have been made under the authority of the Development and Implementation Steering Group (DISG). These respondents raised concerns that the DISG has no powers to make decisions and does not represent a substitute for consultation. Respondents have also raised concerns that decisions often seem to have been made between Ofgem and NGT.
- 3.181. The Authority notes that the terms of reference for the DISG do not provide for it to make decisions regarding the regulatory, commercial, and operational arrangements. In this respect it has been made clear, throughout the DISG process, that nothing presented or discussed at DISG can have the effect of fettering the discretion of the Authority in relation to the decisions it takes on DN sales. Further, Ofgem has exercised care in releasing all documentation on DN sales to the DISG and to broader industry participants through the Ofgem website to ensure that the Authority's discretion is in no way fettered.
- 3.182. The Authority also considers that Ofgem has conducted substantial consultation on the regulatory, commercial, and operational arrangements²⁷ and notes, in this context, that a number of the buyers have commented upon the open and participative nature of the consultation process.
- 3.183. The Authority does not accept that decisions have been made between Ofgem and NGT. Instead the Authority considers that there have been a number of issues that have been raised by Ofgem for discussion through an open and

²⁷ In addition to the DISG process there have been consultations on a number of regulatory impact assessments regarding the regulatory, commercial and operational arrangements as well as consultations

transparent DISG process that may not have otherwise been effectively addressed had NGT proceeded with its original DN sales proposals. These issues include the scope of the agency arrangements, the scope of the offtake arrangements as well as the creation of the Joint Office for the governance of network code and pricing methodology change processes.

Private Collective Licence modification provision

- 3.184. A number of respondents raised concerns that Ofgem does not have the power to restructure the GT licences of Transco and the DNs in a manner that provides for a licence based collective modification process that sits outside the statutory collective licence modification process within the Gas Act.
- 3.185. The Authority has considered these concerns but continues to be of the view that it is appropriate to introduce the private collective licence modification procedure and that it is important to have a collective modification procedure that can apply in the context of a divested industry structure. A further discussion of Ofgem's reasons for introducing the private collective licence modification procedure is contained in chapter 4 of Ofgem's November 2004 licensing paper.²⁸

Request for consent to dispose of land

- 3.186. As noted above, Transco has also applied for an associated consent under Paragraph 3 of Schedule 3 to the Gas Act to dispose of any right or interest in land (which falls within the assets of the four DNs it is proposing to dispose of) acquired compulsorily under the powers of acquisition contained in Schedule 3 to the Gas Act. The Authority has considered this request and has provided its consent, having been satisfied that the land was acquired by a gas transporter and will continue to be used by a gas transporter after the sales transaction has completed.

regarding the licence regime necessary to support a divested industry structure.

²⁸ *National Grid Transco – Potential sale of gas distribution network businesses – Licensing: Next Steps, Formal consultation under section 23 and informal consultation under Section 8AA of the Gas Act 1986*, Ofgem, November 2004.

4. Conditions to consent and way forward

- 4.1. This chapter summarises the conditions that the Authority has decided to attach to its consent to Transco to dispose of four DNs to its four wholly owned subsidiary companies. It also outlines the way forward with respect to the implementation of the proposed sales transaction.

Power to impose conditions of consent

- 4.2. As noted above, the Authority has granted its consent under ASC 29 of Transco's GT licence to enable it to dispose of four DNs to four wholly owned subsidiary companies. In granting consent, the Authority has power to impose conditions on Transco in accordance with the terms of ASC 29. The Authority has chosen to exercise this power in the case of DN sales and has attached a number of conditions to its consent which are considered below. These conditions have been imposed as part of the four Consent Directions which form Appendix 2.

Authority's objectives

- 4.3. In deciding to impose any conditions to its consent, the Authority is required to have regard to its statutory objective and duties as set out in the Gas Act and its public law duties. It also needs to have regard to the statutory and licence obligations of GTs.
- 4.4. Consistent with its principal objective as set out in Section 4AA of the Gas Act, it is important to note that in imposing any conditions the Authority should seek to protect the interests of customers.
- 4.5. In addition, under Section 4AA(5A) of the Gas Act, the Authority must have regard to the principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed. The Authority must also have regard to any other principles appearing to it to represent the best regulatory practice.

Rationale for conditions to Authority's consent

- 4.6. The Authority has decided to consent to the proposed disposal of the four relevant DNs from Transco to its four wholly owned subsidiary companies, at a stage when the details of proposed regulatory, commercial and operational arrangements are still being consulted upon and developed. This work includes a significant number of modifications to each of the six existing Transco GT licences which is being led by Ofgem as well as the establishment of uniform network code and other arrangements which is being led by Transco.
- 4.7. In providing its consent to the hive-down of DN assets to the four wholly owned Transco subsidiary companies, the Authority has had regard to this and has taken the view that it is important for it to ensure that it is satisfied that the regulatory, commercial and operational arrangements that are to be developed over the coming months protect the interests of customers and are therefore consistent with the Authority's statutory objective and duties. In order to achieve this, the Authority has decided to impose conditions to its consent relating to the development and implementation of these arrangements.
- 4.8. It is also considered important that conditions to consent remain in place until the shares in the four wholly owned subsidiary companies are sold to third party purchasers. This is because Ofgem intends to propose modifications to the NTS and DN licences in May 2005 (following the scheduled hive down date of 1 May) to consult upon the introduction of interim incentive schemes for the NTS and DN businesses. In addition, it is also likely that further licence modifications may be required to the NTS and DN licences to address issues arising out of the Section 8AA and associated Section 23 licence modification consultations to be issued in February 2005.
- 4.9. Furthermore, at this stage the Authority is not aware of all the potential issues which could arise associated with the detailed development of the regulatory, commercial and operational arrangements. Some of these issues may only become apparent after hive down.
- 4.10. The Authority has therefore imposed a condition to its consent that Transco is not permitted to sell the shares in the four wholly owned subsidiaries to new purchasers without the Authority's further consent. This will enable the Authority to ensure that the licence arrangements, including without limitation, the interim incentives, are in place and protect customer interests before the

share sale occurs. Further, the Authority considers that it is necessary for it to retain a consent over the share sale given that other issues may arise through the development of the detailed regulatory, commercial and operational arrangements that have not yet been anticipated and would need to be addressed before share sale in order to ensure customers interests are protected in a multi-gas transporter environment.

Conditions to consent

- 4.11. In order to ensure that appropriate regulatory, commercial and operational arrangements are put in place to protect the interests of customers in a divested industry structure, the Authority has imposed conditions to its consent that cover two separate phases.
- 4.12. As part of the first phase, there are conditions precedent which are to be discharged prior to the proposed hive down of DN assets to the four wholly owned subsidiary companies. These are referred to as Phase 1 conditions. As part of the second phase there are conditions subsequent to the hive down. These conditions would need to be met before Transco can proceed with selling the shares in the four wholly owned subsidiary companies (which will at that stage own the DN businesses) to the third party purchasers. These are known as Phase 2 conditions.
- 4.13. It is important to be clear that while the conditions are split into two phases, all elements must be fully complied with by Transco before the transaction can proceed. The Authority is of the view that the conditions it has attached to its consent are reasonable, proportionate and necessary to protect the interests of customers. As noted above, copies of the four Consent Directions containing these conditions can be found in Appendix 2 to this document.

Phase 1 conditions

- 4.14. In summary, the Phase 1 conditions provide that Transco is not permitted to hive down its DN assets into its four wholly owned subsidiaries until:
- ◆ Transco has consented to the modifications to its six GT licences necessary to support a divested industry structure and that these modifications have become effective;

- ◆ The Authority has consented under Section 8AA of the Gas Act to transfer of the four GT licences relating to the proposed independent DNs from Transco to each of Transco's four wholly owned subsidiary companies respectively;
- ◆ The Authority is satisfied as to the proposed arrangements as part of DN sales for industry codes including, (without limitation) the Uniform Network Code arrangements, and has directed the implementation of Transco's proposed modification to its existing network code to create a short form network code that references the UNC;
- ◆ The Health and Safety Executive has accepted the safety cases of each of the four wholly owned subsidiary companies (and of Transco in respect of the NTS and the DNs it is proposing to retain) pursuant to the Gas Safety (Management) Regulations 1996;
- ◆ The Secretary of State has consented to the proposed hive down of DN assets to each of the four wholly owned subsidiary companies under ASC 29 of Transco's GT licence. As noted above, the Secretary of State has now granted this consent;
- ◆ All other consents, approvals et cetera relating to the hive down of the four DNs to the four wholly owned subsidiary companies have been unconditionally obtained;
- ◆ The Secretary of State has granted the proposed exemption under Section 6A of the Gas Act to Transco's NTS business and the DNs in respect of the proposed offtake arrangements;
- ◆ Transco has procured respective undertakings from NGT and the proposed purchasers that each respective party will refrain from actions that would be likely to cause Transco to breach any of its obligations under the consent or which would be likely to prevent Transco from taking appropriate steps to satisfy any conditions to consent and that each party will use its best endeavours to ensure that the enduring offtake arrangements are implemented by 1 September 2005. Details of conditions relating to the implementation of the enduring offtake arrangements are set out below.

- 4.15. As noted above in chapter 3, the Authority has also imposed certain conditions to its consent related to the implementation of the enduring offtake arrangements.
- 4.16. The first of the conditions to consent relating to the implementation of the enduring offtake arrangements is that Transco must procure an undertaking addressed to the Authority from NGT, specifying that NGT will, prior to the proposed section 8AA (and related section 23 licence modifications) to the six Transco GT licences becoming effective, use its best endeavours to ensure that steps are taken to implement the enduring offtake arrangements by 1 September 2005.²⁹
- 4.17. The second of these conditions is that Transco must procure undertakings addressed to the Authority from each proposed third party purchaser that prior to the completion of the sale of shares to the new purchaser, each purchaser will use its best endeavours to ensure steps are taken to implement the enduring offtake arrangements by 1 September 2005.
- 4.18. The four Consent Directions also specify that if any of the conditions attached to the Authority's consent are not satisfied by 1 May 2005 or if the Authority is of the opinion that any such condition is not likely to be satisfied by that date, then the Authority shall be entitled to extend the period for satisfying the conditions to an alternative date or to waive or modify the conditions.

Phase 2 conditions

- 4.19. In summary, the Phase 2 conditions provide that Transco cannot sell the shares in its four wholly owned subsidiary companies without the Authority's prior consent. In addition, the Phase 2 conditions provide that Transco shall consent to any licence modifications and implement any other regulatory, commercial or operational changes following hive down that the Authority considers are necessary in order to ensure that the proposed sales transactions are implemented in a manner that ensures that the interests of customers are protected.

²⁹ The enduring offtake arrangements are described in chapter 5 of Ofgem's Final IA. NGT sale of gas distribution networks – Authority decision document
Office of Gas and Electricity Markets

- 4.20. As noted above, these conditions are considered necessary given that Ofgem intends to issue a Section 23 notice in May 2005 to modify the NTS and DN licences to, amongst other things, incorporate interim incentive arrangements following the scheduled hive down date. Further, it is necessary for the Authority to retain control over the share sale given that other issues may arise through the detailed development of the regulatory, commercial and operational arrangements that have not yet been anticipated and addressed.
- 4.21. It is also noted that the Authority would not envisage consenting to the share sale until it is satisfied (without limitation) as to the financing structures of the proposed purchasers of the DN businesses and until the HSE has accepted the safety cases of these proposed purchasers.
- 4.22. In issuing this decision document it is important to make clear that that there can no expectation on the part of NGT, Transco, potential shippers, suppliers or any other interested parties as to any further decisions which the Authority may be required to take or any further consents which the Authority may be required to grant (including for the avoidance of doubt any decisions or consents which may be necessary pursuant to a condition precedent or a condition subsequent attached to the consent granted by the Authority on 20 January) in relation to the proposed transaction. The Authority's discretion will not be fettered by the issuance of this decision document or by any statement made within it or in the appendices.

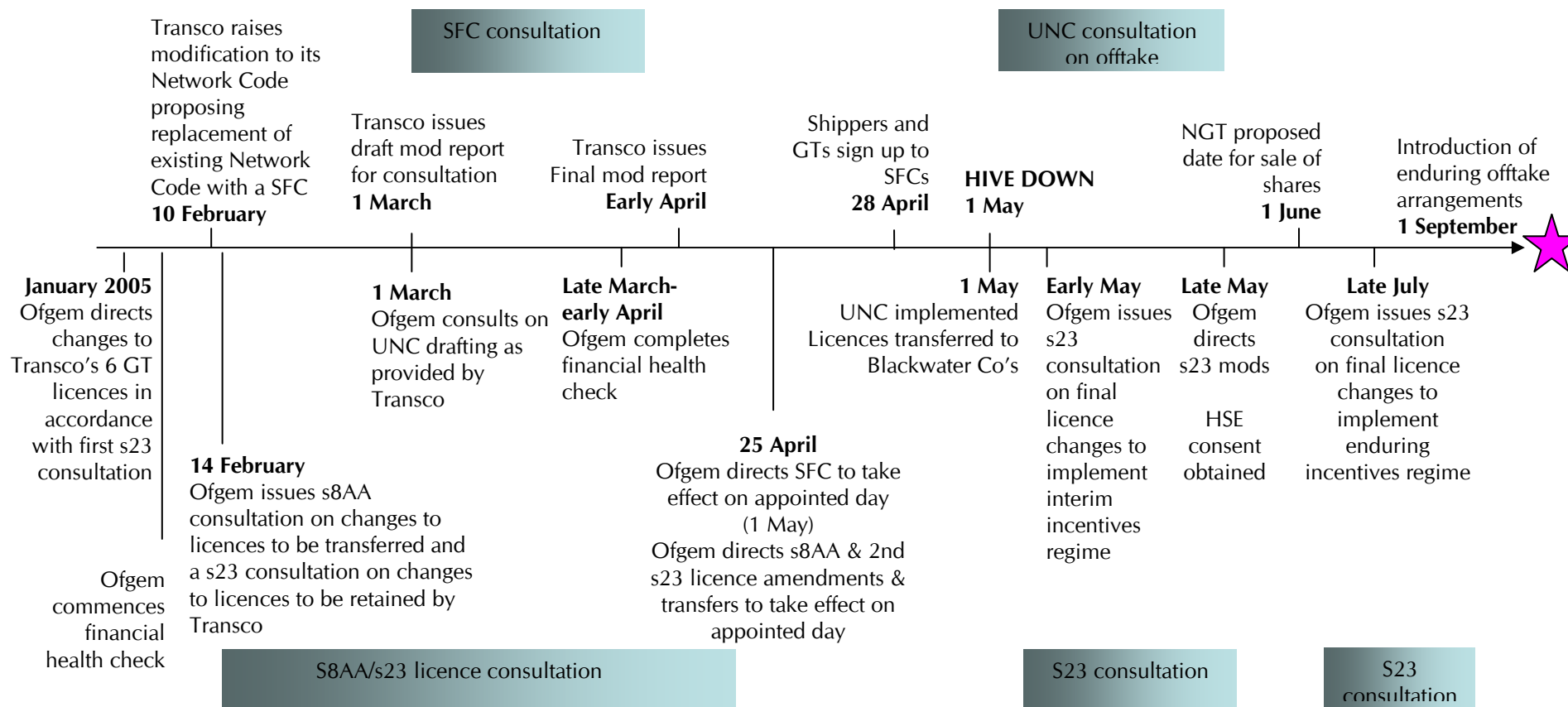
Way forward

- 4.23. The implementation of the proposed sales transaction is now scheduled to proceed through an extensive consultation process covering a combination of Ofgem led consultations on licence modification proposals, as well as Transco led pricing methodology changes and network code modification proposals (including that relating to the creation of Transco's short form code that references the proposed UNC) with the hive down of the DN assets to Transco's four wholly owned subsidiary companies scheduled to occur on 1 May 2005.
- 4.24. In addition to these processes, Ofgem intends to issue its own consultation on the final legal text of the UNC so that it can consider representations made when it determines whether to direct the modification to Transco's existing network

code to create a short form code that references the UNC. Ofgem expects to issue this consultation in early March.

- 4.25. Given the Authority's decision that the enduring offtake arrangements do not need to be implemented prior to the completion of the DN sales transaction, Ofgem therefore intends to issue two separate Section 23 consultations on the licence modifications necessary to implement interim and enduring incentive arrangements for the NTS and DNs. The first of these consultations with respect to the interim incentive arrangements to be in place at the time of the proposed sale transaction will occur in May 2005, whilst the second with respect to the introduction of enduring incentives to apply from September 2005 will occur in July 2005.
- 4.26. The way forward is summarised in Figure 1 below.

Figure 1 Way forward



Appendix 1 Transco's applications for consent

This appendix is attached.

Appendix 2 The Authority's Consent Directions

This appendix is attached.