



National Grid Transco – Potential sale of network distribution businesses

Agency and Governance Arrangements

Regulatory Impact Assessment

A Response by British Gas Trading

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EXECUTIVE SUMMARY

In considering these RIAs, we have focused on the processes that will be necessary for smooth implementation. We believe that these processes must be fully understood and any associated costs properly quantified before the next decision point in July.

British Gas has reviewed the information presented in the document and whilst progress has been made, we continue to have a number of concerns.

We agree that the formation of an agency would be expected to mitigate the cost impact of the proposals on customers and the suppliers/shipping community. Our support for an agency is, however, contingent upon the agency model chosen.

Our comments are divided into general and specific issues:

General Issues:

- We believe a consultation should take place on the Full RIA (based on this and the other 4 RIAs) prior to submission to the Authority in July, recognising the developments made since the Partial RIA, previously published.
- The lack of aggregate quantitative cost/benefit information and the omission of the “no change” scenario as an option impedes consultees from responding fully and constructively to the RIA.
- Consideration is required on changes needed to the incentive elements of the GT Price Control to ensure that consumers are not disadvantaged.
- Clarification and assurances are needed on when benefits will start feeding through the DN Price Controls.
- The absence of information in respect of transitional issues means that a potentially significant category of costs is not accounted for.

Specific Issues:

- The selection of sale, no agency, as the base case for the comparison does not assist the evaluation of options, unless the full costs associated with this scenario are analysed.
- Structure, ownership, governance and funding of the agency are not yet sufficiently resolved
- Provisions for future exit from the agency or indeed any Day 1 arrangements need to be carefully planned in advance to prevent future costs as a result of this process.
- The creation of a separate governance entity from the agency would benefit from further discussion and cost evaluation prior to a decision being made
- Siteworks, Connections and Metering should be included within the Agency arrangements, either by selecting option F, or by selecting option E and adding Siteworks, Connections and Metering.
- The potential for divergence of charging methodologies and structures may create additional costs at a later date unless some restrictions are employed.
- An agreed process such as a bi-annual window for transportation charge changes is needed, to reduce industry costs of managing price changes.

Conclusion

In our opinion the best combination of DN and Agency model to minimise industry disturbance, mitigate costs and so enhance potential benefits is Active DN/Agency Option F or Active DN/Agency Option E, with the addition of Siteworks, Connections and Metering.

INTRODUCTION

Following on from the Authority decision to allow further work, we have focused on the processes that will be necessary for smooth implementation and we believe these processes and any associated costs must be fully understood and properly quantified before the next decision point.

This document forms British Gas' response to the RIA on Agency and Governance, and as far as possible is intended to be a stand-alone response. However, due to the interactions with other RIAs (both published and expected) and ongoing work on sales of the distribution networks, some common ground is inevitable.

British Gas is also of the opinion that the interdependencies in the industry mean that these decisions cannot be made in isolation, and that an iterative process is required, particularly due to Ofgem's mini-RIA approach. We therefore expect to comment further in these areas once the additional RIAs due in June have been published. Our views stated in this document are all subject to change when further information in respect of the overall regime becomes available.

The approach taken in both this response, and our response to the RIA on allocation of roles and responsibilities between transmission and distribution, is to raise general issues with the approach followed by Ofgem in producing the RIA first, followed by specific points. This means that some text will be common to both responses.

In responding to the RIA on Agency and Governance, we have relied on Transco's representations that there will be no change whatsoever to the SPA flows. We would like to re-iterate that if this proves not to be the case, costs are likely to be very high.

Whilst not specifically linked to the RIA, we remain very concerned in respect of the potential costs associated with the Supplier Licence requirement, to keep the customer advised of the name of the Transporter. We are aware that Ofgem is considering this issue, and would urge that it be addressed in the Commercial and Regulatory Framework RIA due out in June.

GENERAL ISSUES

1) Consultation on the Full RIA

The approach taken by Ofgem in producing a series of “mini RIAs” is useful in drawing out issues specific to particular areas. However, British Gas is concerned that breaking down the project in this way will increase the difficulty for participants of forming a clear, overall view of the net project position.

British Gas believes that consideration of groups of costs and benefits in isolation may lead to an inaccurate result. It is likely that some combinations of, for example, Agency and DN roles, when taken together, will either reduce or potentiate costs and benefits.

In order to ensure that all participants are aware of the overall picture of costs and benefits, we believe Ofgem should make a commitment to the industry that the Full RIA (including aggregate quantitative material) will be issued for formal consultation prior to its submission to the Authority. This will provide an opportunity for all parties to comment holistically on the information being provided to the Authority for its July 04 decision.

In the absence of such a consultation, major decisions will be made affecting all industry participants, based on material those participants will not have seen and may not be able to support.

2) Lack of aggregate cost/benefit information

In the RIA document, much of the information provided appears to be based on Ofgem’s qualitative assessment of the issues using a system of ticks and crosses. The lack of definition of these symbols precludes respondents from achieving a realistic assessment of relative magnitude. It is also unclear whether the number of symbols applied corresponds to consistent sums in all cases, for example, one tick equates to £Xm, two ticks equate to £Ym in both RIAs.

In addition to the above, the method of using qualitative information via the ticks and crosses lacks rigour, since the relative costs do not appear. The lack of explicit cost material prevents respondents from either challenging or refining Ofgem’s assessment. In our view this will impact the quality and detail of responses provided, as participants cannot offer support to Ofgem’s view without such information and hence would need to attach caveats.

Ofgem has indicated that the need to protect individual participant confidentiality is the reason why such information has not been provided. British Gas is of the view that Ofgem could publish aggregated cost benefit information, or a minimum and maximum range scaled to reflect all participants, without causing participants concern. This approach, by providing a greater degree of transparency, would enable all respondents to form a clearer understanding of Ofgem’s reasons for decisions and the overall likely net position.

In the absence of quantitative information, which would also need to include detailed documentation of the underlying assumptions, respondents cannot properly assess whether costs and benefits are being compared on a like for like basis, or whether the net position is a benefit to customers.

3) Omission of the “no change” scenario

We have major concerns about the fact that Ofgem have used a base case which is not the status quo, without any analysis of the costs (benefits) of getting to that position. This approach means that the relative case and costs could mask the harm in the base case.

In our opinion, two possible approaches would be acceptable as the basis for a robust RIA; either

- Use the “no change” scenario as the base case; or
- Select a scenario to use as the base case, but quantify the costs of getting to that scenario, and factor them in to the cost benefit analysis.

Ofgem’s approach has been to select a scenario, but not to quantify the associated costs of getting to that scenario. British Gas considers this approach to be insufficiently robust as the basis for the Authority decision.

British Gas continues to believe that the RIAs for the DN Sales project must address the issue of Price Control Separation in order to be robust. The reason for this belief is that either:

- Price Control Separation was required to facilitate DN sale, hence both the costs and benefits should be included in the RIA. This would mean that the costs of regional pricing should be included in the RIA; or
- Price Control Separation was implemented as a stand-alone change, in which case the associated benefits should be quantified and only those benefits additional to those stemming from Price Control Separation should be included in the DN sales RIA.

The current position, where the benefits of Price Control Separation are (by implication) included and costs are not, is untenable.

However, if the latter option is chosen, it should be recognised that following sale, the opportunity for smoothing regional impacts will have been lost.

4) Transco’s GT Price Control

British Gas appreciates that Ofgem has not yet published detailed proposals in respect of the roll forward of Transco’s Price Control to 2008, however, we are of the opinion that a number of points need to be resolved prior to preparation of the Full RIA, and guidance provided.

Ofgem has made reference in the document to aspects of the GT price controls. One example is the confirmation that passing through of costs associated with losses of economies of scale will not be permitted, these being viewed as purchase costs. In our opinion it will be very difficult to achieve this outcome because there will be no relevant counterfactual against which to assess any losses of economies of scale when carrying out future price control reviews, i.e. it will not be possible to quantify or separately observe these losses. We consider it would be helpful for Ofgem to provide an explanation in advance, as to it believes this can be achieved.

We list below a number of key issues that we believe require urgent resolution to ensure a stable basis for the regime going forward:

a) GT Incentives

Post DN Sales it is important that the incentives on GT behaviour are not diluted or weakened in any way. We believe that the relevant incentive structure should be replicated wherever possible for DNs. British Gas is of the view that with Active DNs, this is absolutely essential, and that to leave this issue unaddressed until the start of the next price control period would be wholly unacceptable. In the absence of revision to the incentives, we believe that the benefits claimed should be reduced, as the efficacy of the current incentive regime would be degraded.

If appropriate incentives are to be applied to DNs, it is important that the framework for these incentives is known prior to sale, to ensure prospective purchasers can factor these in to the purchase price. The framework will need to ensure that all DNs (RDNs and IDNs) are consistently incentivised.

British Gas is also of the opinion that given the commercial imperatives on new DN owners, consideration should be given to strengthening incentives to ensure that customers, industry participants and the physical assets are properly protected.

In addition to the previous points on GT incentives and a lack of discrimination, we believe that the incentives currently applied to Transco may require review to ensure that they dovetail with incentives placed on DNs, achieving the required result. It is likely that detailed modelling will be needed in this area, to ensure that the incentives on the NTS (and possibly RDNs) do not perversely incentivise Transco to act in ways that might be detrimental to other parties.

b) Pass through of benefits

We acknowledge that the sale of some of the DNs into separate and independent ownership will introduce the possibility of real benefits arising through comparative regulation. However, we remain sceptical that any of these benefits will be revealed in the process leading up to the next price control review even if this has a delayed effective date of 2008. This being the case, significant benefits will only become available to shippers/suppliers (and hence customers) after the next price control review in 2013.

This is as a consequence of the standard Ofgem practice of using a single year's data as the base year to produce the future price control revenues. The first base year which would be expected to contain beneficial effects of DN Sales would be 2010/2011, indicating benefits could be passed through in the 2013/2018 price control. If this premise is correct, the benefits case should be reduced to reflect the costs to customers of this delay.

c) Retention of benefits by GTs

We understand that Ofgem has indicated they are minded to apply the principle of a five year rolling retention period for benefits, as is being discussed under the Distribution Price Control Review. If this is the case, we would welcome Ofgem's assurance that this 5 year retention of benefits by the DNs has been properly quantified, and the value excluded from the benefits figures previously claimed for the project.

5) Timescales and Process

In general terms, we continue to have concerns the lack of detail currently available given Transco's aspirations in respect of timescales for DN sales.

There is still a considerable amount of detailed work required to facilitate sales, and in our view the process to be followed remains unclear. This, together with the lack of certainty around timing, is a risk to the project.

British Gas is of the view that a detailed project plan is needed, with realistic timescales and decision points, followed by a clearly defined implementation phase during which no further change is permitted to allow the industry to implement required business changes.

6) Transitional Issues

British Gas continues to be very concerned about the lack of consideration given to transitional issues. If the DN Sales proceed, the industry will need to make major changes to support the process. In some cases, with proper planning and sufficient notice, a hard cutover may be possible. It is more likely, however, that in some areas transitional provisions will be required, and in some cases transitional processes.

The RIA documents issued so far have considered costs and benefits of getting to the “new world”, however, where transitional arrangements are required, these will also incur costs. In order to arrive at a robust cost benefit analysis for the project as a whole, the costs of such transitional provisions need to be included. It is worth noting that as transitional provisions tend to be no more than a “stepping stone” on the way to a permanent solution, the costs incurred generally have extremely limited offsetting benefits.

As the workgroups to date have not considered transition mechanisms, it is not yet possible to quantify costs, and hence the RIAs will be incomplete. In many cases transition costs for major changes are significant. If this were to be the case on this project, there is a risk that these costs could undermine the basis on which the Authority decision is made.

An additional point to be considered is that in the case of major change or the implementation of a new regime, a significant number of adjustments are needed to fine tune the arrangements, this has been the case both on the Network Code and the BSC. In view of this, we believe it would be prudent to factor in an allowance to cover these costs.

ISSUES SPECIFIC TO THE AGENCY AND GOVERNANCE RIA

In considering the points specific to this RIA, we have again grouped our concerns, where possible reflecting the headings used in the document. We believe that there are a number of areas in which the RIA does not fully address the issues that have been raised.

a) Selection of the Base Case

As with the RIA on Roles and Responsibilities, Ofgem has not evaluated the “no change” scenario. In its place, the base case chosen for comparison is sale in the absence of an agency, the costs of which have not been included. The alternative scenarios are then qualitatively compared to the sale, no agent scenario, and the outcomes presented as cost savings.

British Gas does not consider that this is an appropriate base scenario, and further, we do not accept the fact that Transco has already commenced the development of xoserve, should allow the associated costs to be ignored/overlooked.

In addition, we believe that this approach, by using an unquantified base case, which is not expected to happen, could be viewed as introducing distortion into the consultation process. We concur with Ofgem and other participants that the worst case scenario from the cost perspective would be sale in the absence of an agency, but believe that this option would be more appropriately presented as one of the alternatives rather than the base case.

In the table summarising the qualitative evaluation of options A-F against the sale, no agent scenario, we note that Ofgem considers sale, no agent to be balanced in terms of costs and benefits. Whilst in the absence of definitions of the values ascribed to the ticks and crosses, we cannot confirm or dispute this, in our opinion, the costs likely to be associated with this option would be so high, that we are unable to support the evaluation.

b) Potential range of activities for the agency

We are in agreement with the selection of most of the activities listed for possible inclusion within the agency, but are concerned that some important areas do not appear to be discussed. It may be that they are simply incorporated within other headings, but we would welcome reassurance on this point. The areas where costs will arise outside the proposed agency include, inter alia:

- DM Reading
- DM Maintenance
- Notifications of Interruption
- Provision of CV Information
- Incident notifications
- Transitional provisions on Unique Sites/Primes & sub-deducts
- LPG Networks
- Scottish Independent Networks

c) Structure, ownership, funding and governance of the Agency

We believe that there are a number of issues that have not yet been fully addressed in this area. We also believe that if a governance entity is to be created, the issue of the agent needs to be considered alongside it.

We understand Ofgem’s view that it may not be possible to implement enduring arrangements ahead of the next price control, but we believe that the broad framework for the enduring structure needs to be in place prior to sale in order to provide a degree of confidence among the community and prospective purchasers for planning purposes.

In view of this, we support the contention that Transco should produce ABC analysis of the costs of agency (indeed, we thought they already did so) as preparation for the next price control. In our view, collection of information in this area should begin as soon as possible to ensure that savings can be passed through as soon as possible.

We also note Ofgem's view that additional costs associated with the Agency should not be passed to customers but should be met out of existing revenues. It is also not clear how such costs can be accurately quantified and excluded from future price controls.

In the long run, we are of the view that the Agency/Governance Entity will need to be separately licensed, funded and governed. We also believe that in the case of both organisations, industry involvement should be sought at all stages, and levels.

d) The Governance Entity

We note in the document that Ofgem has a clear preference for an agency option that includes a separate governance entity. British Gas is not opposed to this in principle, but is unable to fully support the proposal in the absence of further information on how such an entity would be operated and governed.

Whilst we understand Ofgem's view that some of these issues may have to be considered for the next price control review, we are of the opinion that once the entity is formed and operational, further change will be very difficult, and hence that as many of these issues as possible need to be resolved in advance.

Our key concerns in this area are listed below:

- The need to understand in advance of formation, the precise role, function and "governance" of the governance entity (GE). This includes:
 - Whether the entity would have obligations in its own right, or
 - Whether it would function as a fulfilment house.
 - Whether the GE and Agency would be separately funded
 - Whether an unincorporated vehicle is appropriate for the GE
 - Governance and control of the GE
 - Licensing/regulatory oversight of the GE
 - Resolution of disputes /escalation processes in respect of the GE
 - Standards of Service for the GE
 - How the GE would interact with the agency, and which will take precedence
 - How the GE will interact with the Modifications Panel, NWC committee and the various sub committees and workstreams.
 - If the GE is an administrative function, and operates as chair, the chairman's casting vote must be reviewed in all cases.
- If a separate GE is formed, it will be important to ensure that the lessons of previous experience are learned in order to improve the service provided to the community in future. This will include ensuring that robust controls around the costs of the governance function. Presently, the fact that this function is carried out under Transco's price control, ensures that a downward pressure is maintained on costs. If this is no longer the case, a reduction may be required in the benefits case to reflect the absence of this constraint.
- A full review of the Modification Rules and the provisions in respect of NWC administration will be required in order to functionally separate the development and administrative roles. Ofgem has categorised the issues in this area as being for future development in the workgroups. British Gas supports the view that additional debate is needed, and believes that this review should be concluded pre hive-down/sale and prior to formation of the GE. Dependent on the Network Code option selected (i.e. Shortform Codes or Framework Agreements), it will be important to consider whether additional

panels and committees may be needed for any Shortform Codes.

- We note the initial proposal that the governance entity would be an unincorporated joint venture between Transco, the RDNs and IDNs. Given the importance of the function to the industry, we would be very concerned if all industry participants, especially Shippers and Suppliers, were not fully involved in the development of this entity at all stages, even if ownerships rests with the GTs for the remainder of this price control period.

Finally in this area, we believe that to implement a separate GE in this way will require a considerable amount of development. In order for the community to fully support this proposal, we believe it would be helpful to draw out a timeline and begin discussions on some of these issues.

e) Charging Methodology and Development

All the options, which make provision for a separate governance entity, include the administration of transmission and distribution charging within its remit. Whilst we support common administration for these processes, we do not believe that this alone provides sufficient certainty to participants as to the management of such a key process. British Gas would prefer that a clear licence obligation be placed on each of the NTS and DNs, limiting changes in levels of charges to a common, bi-annual window.

British Gas would also wish to see the licence condition extended to ensure that additional information is provided to the community to assist participants in predicting the future path of transportation charges at a DN level.

In addition to this, we believe that further consideration should be given to the issue of charge structure and underlying methodology, to limit community impact. If a decision is made at a later date to permit divergence of structure and/or methodology, we are of the view that a minimum two year notice period should apply. We hope that Ofgem will evaluate these issues in detail in the RIA on commercial and regulatory arrangements due in June.

f) Restrictive vs. Non-restrictive Governance

In respect of both charging methodologies and Network Code modifications, we are of the view that any fragmentation will require the most detailed consideration and robust justification. As we have previously stated, we have serious concerns as to the effect on the overall health of the industry if fragmentation is permitted.

As noted in our response to the RIA on roles and responsibilities, British Gas believes it is important to distinguish fragmentation and innovation. We would not wish to stifle innovation, as we believe this is the source of much benefit to consumers, our concern is that if fragmentation is not prevented, DNs could use this as a mechanism to avoid implementation of innovative practices, this would be of greater detriment to consumers in the longer term.

If unrestrictive governance is chosen, and proposals are brought forward which would directly or indirectly result in industry fragmentation; we believe strongly that detailed consideration of the costs and benefits on a quantitative basis would be essential prior to a decision being made, as well as consideration of more general issues.

The question of Shortform Codes vs. Framework Agreements has not yet been resolved, we assume that this will be addressed and all aspects fully considered in the commercial/ regulatory RIA due out in June. In the absence of resolution of this issue, we believe the decision on restrictive vs. non-restrictive governance should be deferred.

g) Siteworks, Connections and Metering

British Gas has serious concerns with respect to the proposals in these areas. Participants have an obligation to provide these services and all wish to provide a seamless, cost effective service to their customers. We continue to believe that in the timescales proposed, the most practical solution both for consumers and suppliers is to include Siteworks, Connections and Metering provider of last resort within the Agency arrangements. We believe this to be the least cost option, which at a time of considerable change offers the best chance of minimal consumer impact.

Ofgem reasons that excluding these areas from the agency will stimulate competition and new entrant service providers. British Gas does not support that view. In our opinion, the proposals would result in arrangements similar to those in electricity, where near monopoly local service providers operate fragmented processes. Far from stimulating competition and new entrants, we believe this would result in the creation of barriers to entry and a significant detriment to the fledgling competitive market. Overall, we consider that the simplicity and cost effectiveness of a single interface would encourage new entry and stimulate competition.

At a later date, once competition in these areas is secure, if it is cost effective to do so, we consider that service providers may seek to offer alternatives to the agency mechanism as part of their product offering. Once competition is effective, the obligation on the agency to provide the service could be removed.

h) Demand Estimation and AQ/SOQ Calculation

British Gas notes that in all options except option A, Demand Estimation is allocated to the Agency. Whilst we believe this to be a practical way forward, we are more concerned as to the basis of the calculation. We believe that assurances are needed that the methodology underpinning demand estimation will not be permitted to diverge between DNs, in our view, consistency is essential.

In contrast to the above, in all cases the AQ/SOQ calculation is included within “record and calculate transportation volumes”, and hence is included in the agency. Again, we consider this a practical way forward, but would wish to re-iterate that divergence of methodology should not be permitted.

i) Cost benefit analysis assumptions and methodology

We are disappointed that the appendix does not provide sufficient information in respect of the assumptions and methodology to enable respondents to form a clear view of the relative costs and benefits of the various options.

Whilst we appreciate Ofgem’s concern for participant confidentiality, we believe that it would be possible to include aggregate NPV information, at a community level, showing the expected costs and benefits of the various options in monetary terms. In our view, this information would assist respondents in forming an overall view as to the best way forward for the industry, and so enhance the responses provided to Ofgem.

We also believe that the value of the information that has been provided would be enhanced if the no change scenario were used as the base case.

CONCLUSIONS

British Gas has appreciated the opportunity to comment on this document, and believes that it has made a useful contribution to the debate.

Whilst we understand why Ofgem has chosen to present the analysis in this way (excluding aggregated cost information and the “no change” scenario), we are of the view that this has, unfortunately, significantly reduced the value of the RIA and resulting consultation.

We agree that sale in the absence of an agency would be the worst case, highest cost scenario, but given the creation of xoserve, we do not consider this to be a real option.

In respect of the creation of a separate governance entity, we are not averse to this proposal in principle. However, we believe that the details of how such an entity would be governed and operate have not yet been sufficiently explored to enable respondents to give a definitive view. We would be happy to continue to work with Ofgem, Transco and the community to explore and refine the proposals.

British Gas continues to believe that at present, customers would be best served by selection of Agency option F, which includes connections and metering provider of last resort. We are of the view that the benefits and reduction in costs under this option would outweigh the disadvantages as identified. A further variant would be to select option E, but to include siteworks, connections and metering, at least until competition in these areas is fully developed.

In our opinion the best combination of DN and Agency Model to minimise industry disturbance, mitigate costs and so enhance potential benefits is Active DN/Agency Option F, or Agency option E as amended above.