



**National Grid Transco – Potential sale of network
distribution businesses**

**Allocation of Roles and Responsibilities between
transmission and distribution networks**

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 continues to have a number of major concerns.

Whilst overall we agree that an Active DN model offers the best chance that benefits may be available to customers as a result of DN Sale, we are not persuaded by the RIA that such benefits have been proven and can be assured. An Active DN model also carries the risk of greater complexity, which in turn could lead to additional costs. This would be particularly evident without adequate provision of arrangements by the "Agency". We do not believe that the RIA reflects this potential risk.

The key points are:

General Issues:

- We believe a consultation should take place on the Full RIA prior to submission to the Authority in July, recognising the developments made since the Partial RIA, previously published..
- The lack of aggregate 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 needed 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 absence of analysis on the base case means that the potential net benefit of option 1 cannot be properly evaluated.
- If the Active DN Model is selected, British Gas believes that the best opportunity to generate a net benefit would be provided either by the broadest Agency Option (F), or option E with the addition of Siteworks, Connections and Metering.
- Potential interactions with the RIA on Exit Reform due in June
- Lack of recognition of costs (direct and indirect) faced by Shippers and Suppliers
- Strong regulatory oversight of the SOMSA¹ is required to ensure non discrimination and protection of consumers
- The RIA does not adequately address the prevention of industry fragmentation.

Conclusion

We believe that an Active DN model would be expected to generate the greatest potential for net benefits of the three options, but in the absence of quantitative analysis of this option, the net benefit cannot be proven.

¹ System Operation Managed Services Agreement

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 Allocations of roles and responsibilities between transmission and distribution, 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 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 Agency and Governance, is to raise first general issues with the approach followed by Ofgem in producing the RIA, 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. This would both ensure prospective purchasers can factor these in to the purchase price and provide greater clarity to the wider community on the obligations. 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 were 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.

d) Treatment of Revenues accruing from SOMSA services

British Gas believes that it would be appropriate to provide guidance on how the revenues accruing from SOMSA services will be treated, given that NGT will presumably be providing these services using assets and resources from the price controlled business. We are also of the view (as has been previously indicated) that RDNs as well as IDNs should have a SOMSA, to prevent discrimination. This being so, we believe that clarity should be provided at an early stage on how the SOMSA revenues from RDNs will be treated.

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 ROLES AND RESPONSIBILITIES RIA

British Gas has reviewed the RIA issued and has a number of specific concerns that we consider have not been addressed by the document as published. As in the previous section, we have grouped the issues together.

a) **Lack of costs for the base case.**

Ofgem has selected the Active DN model as the base case and compared the Passive and Hybrid models to it. The comparison is made in terms of loss of potential benefits rather than costs, and the costs of implementing the Active DN model are not quantified. In the absence of such information, our comments must be considered as being subject to cost.

Whilst in principle we agree that the Active model offers greater potential for savings to a prospective purchaser, in the absence of quantified costs for this model, we are not persuaded that a net benefit to consumers would accrue. This point is particularly important in the light of our comments in the previous section on retention of benefits by the DNs and GT incentives.

b) **Assessment of the Active DN Model**

Ofgem has stated in the RIA document its preference for an Active DN model, we understand the reasoning behind this view, but if this is the option chosen, we believe that a number of points require consideration which have not been included in the RIA.

In the light of Ofgem's clearly indicated preference, we have concentrated on reviewing the main issues we believe would be associated with the Active DN model.

1. **Agency Model**

If the Active DN model is selected, then unless a broad Agency option (either Option F or option E with the addition of connections and metering) is chosen, industry participants will have to interact with more than one entity as a direct result of DN Sale. This being the case, it will be necessary to include provision for Shipper/Supplier costs rather than the current approach of including only GT and Ofgem costs.

The document does refer to the Agency RIA in this area, but in our view, this issue is not fully covered. Please refer to our response on the Agency and Governance RIA for further comments on the Agency Model.

2. **Overlap with planned RIA on Exit Reform**

British Gas is concerned that the Active DN Model, with its assumption that DNs would be contracting for interruption on their networks, might be seen as anticipating or prejudging the outcome of the debate and expected RIA on Exit Reform.

In view of this, we believe the RIA needs to include additional detail on which party would be contracting with whom, for what service. It is also unclear whether the Active DN model could be effective where DNs simply call interruption under the existing interruption arrangements. At the very least, detailed consideration would need to be given to the resulting price control treatment of this option. The RIA needs to include community/consumer costs of putting in place revised contractual arrangements with DNs, if they do contract directly for interruption.

3. **1 in 20 Investment and Planning Obligation**

Whilst the issue has been discussed in the RAWG, if all DNs have the 1 in 20 investment and planning obligation, and if an Active DN model is chosen, it will be necessary to ensure that it does not lead to unnecessary or inefficient reinforcement of the system and hence increased costs to customers. This risk is viewed as greater

under the Active DN model than under the other two options where a single entity retains responsibility for planning.

In addition, British Gas believes it is essential that the methodology for assessing 1 in 20 requirement be documented in detail to ensure that all DNs would be compelled to carry out such calculations on a consistent basis. If the obligations in this respect were only contained within the SOMSA, unless the Authority held a right of veto over change, there is a risk that the methodologies could diverge over time to the detriment of system security and hence customers. Our preference would be for the GT licence condition to contain obligations as to the basis of the calculations as well as obligations to meet the 1 in 20 security requirement.

4. Costs arising from Losses of Economies of Scale

The document notes that costs associated with losses of economies of scale will not be passed through to consumers as these would be deemed to be costs of sale by Ofgem. British Gas welcomes this reassurance, but is concerned that it will prove very difficult to implement. Please refer to our comments under point 4 in the previous section.

We believe that to provide certainty to both consumers and prospective purchasers, it would be helpful for Ofgem to explain prior to the sales taking place, how this will be effected.

5. SOMSA

We raised a concern under point 4 of the previous section on how revenues accruing from the provision of SOMSA services will be treated under the price control. In addition to this point we have serious concerns on how the SOMSA will be governed.

It is our understanding that Transco proposes that the SOMSA will be a confidential bilateral agreement between Transco and the DN owner. British Gas is of the view that given the importance of this agreement to the management and security of the system, the document should be subject to regulatory oversight, and that change should not be permitted, in the absence of Ofgem and HSE approval.

In addition, whilst we appreciate that some details may need to be confidential, we believe that much of the document would be standard, and could be placed in the public domain in the same way as Standard Licence Conditions are. This would have the advantage of improving transparency and reducing the risk of discrimination.

6. Gas balancing

British Gas agrees with both Ofgem and Transco that the only practical way forward in respect of gas balancing is for a single system operator, and further that the responsibility for this role should rest with Transco NTS.

7. Loss of Operational Synergies

The document asserts that it is possible to distinguish gas balancing and constraint management in almost all cases, and hence that significant costs are not expected in this area under option 1 (the Active DN model). The interactions between energy and capacity on the system are well known, and the difficulties associated with distinguishing actions taken for system balancing and constraint reasons have been discussed in various fora. As each will be subject to incentive arrangements, it would require close scrutiny in order to ensure that no perverse incentives exist.

The assurance that actions can be distinguished in this way is welcome, but we would like clarity on how this will be monitored and reported to the community. In addition, we are not sure why simply distinguishing the two types of action would indicate

insignificant costs; in our view it would simply facilitate attribution. We believe it would be helpful if Transco were to submit a paper to DISG, including some modelled examples, clarifying this point.

8. Industry Fragmentation

British Gas shares the view of a number of industry players that an Active DN is more likely to seek fragmentation of key industry processes through divergence of network code and charging arrangements.

Whilst we agree with Ofgem that it would be possible to put in place robust governance arrangements to provide regulatory certainty in this area, we do not believe that the Agency and Governance RIA contains sufficient detail to provide reassurance on this point. We will continue support the work ongoing in this area to improve the governance proposals going forward.

British Gas believes it is important to distinguish innovation and fragmentation. We would not wish arrangements to be put in place that would prevent future innovation that would be beneficial to consumers and the community. We are concerned that if fragmentation between DNs were allowed, this would permit DNs not to adopt beneficial innovations that would improve the service received by all consumers.

It is also important to recognise that whether fragmentation happens on day 1 or x period of time later, costs would still be incurred and would be expected to reduce potential benefits from the DN sales process.

9. Cost Benefit Analysis Assumptions (Appendix 2)

We have reviewed the information provided at a high level and have a number of concerns:

- a) With the Active DN model (especially absent Option F for the Agency), we do not believe that it is appropriate to discount Shipper or Supplier costs, as these will inevitably be passed on to consumers. The Cabinet Office guidelines on RIAs specifically note that indirect costs and benefits should be included.
- b) It is not clear how the possible retention of benefits for a rolling five year period has been factored in to the analysis
- c) We believe table A2.2 may contain an error, and that the column heading should be "OPEX allocation under each option".
- d) The analysis does not reflect the benefit detriment that would result if more than one DN is sold to a single entity; it assumes instead that all are sold to different owners. If more than one DN is sold to a single entity, this assumption will have significantly overstated the benefits case.
- e) The analysis does not recognise the costs inherent in implementing option 1.

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.

Overall, we agree that the Active DN model offers the best opportunity for the creation of benefits to consumers, but this view is subject to a fuller understanding of the costs associated with implementing this option. We reserve the right to comment further if additional information becomes available.

If the Active DN model is chosen, we believe that a number of points need to be addressed in more detail than has been provided in this document. These points have been described in detail above, but we believe the Agency Model selected is paramount.

In our opinion the best combination of DN and Agency Model to minimise industry disturbance, mitigate costs and so enhance potential benefits is either Active DN/Agency Option F, or Active DN/Agency Option E with the addition of siteworks, connections and metering.