



## **Gemserv Response To “National Grid Transco – Potential Sale Of Network Distribution Businesses, Agency And Governance Arrangements, Regulatory Impact Assessment, April 2004”**

### **Executive Summary**

As the leading independent provider of governance services to the retail energy markets Gemserv has unique operational experience, and a keen interest in promoting best practice, within the industry governance regimes. As such Gemserv sees the potential sales of Distribution Network businesses as a pivotal opportunity to set the scene and outline the “road map” for the governance architecture of the gas industry for the foreseeable future.

Gemserv welcomes and supports the concept of an independent Governance Entity and believes this should be created in such a way that the services it provides are exposed to competitive pressure. In our view it would be inconsistent with the principles of governance to leave the operation of the governance regime within the control of one dominant stakeholder or stakeholder group. It seems entirely practical for a competitive tendering exercise to be carried out for this service, in parallel with the DN sale process.

Gemserv believes that the Agency role should be constructed in such a way that it, or at least appropriate service lines, can also be made subject to competitive pressures. Once again, it would be incompatible with the principles of furthering competition and lowering the regulatory burden, to move regulated assets into this entity and require it to be licenced and regulated. There is surely no compelling case for the creation of a further licenced monopoly business where a competitive, alternative solution can be established.

Gemserv has some concerns that the RIA appears to have adopted as the “base case”, a scenario where DNs have been sold but no Agency has been created. In fact the base case should properly be no DN sale. This makes every option more attractive and cost effective than the base case and may prove to be a distortion that could be prejudicial to sound decision making. This is especially true as the final RIA



on the case for sale (into which the results of the present RIA will feed) is not itself intended to be the subject of formal consultation.



## Specific Points

### 1. The “base case”

- 1.1. The basis of the costs and benefits included within the RIA appear questionable and may lead to unsafe conclusions as each option is compared to a base case which itself is founded on a suspect premise.
- 1.2. Paragraph 1.2 of the document states that “...the framework that is developed will form the basis of an alternative to the present Transco owned and operated transmission and distribution arrangements.”. However, the costs and benefits of the various options discussed in Chapter 7 take as the base case DN disposal with “No Agency” rather than “no change”. This seems inconsistent and may distort the various comparisons drawn in the RIA.
- 1.3. As pointed out in paragraph 2.7, Transco has already “...created a separate internal business...” (called xoserve) which “...will provide services to Transco irrespective of whether a sale of one or more DNs proceeds.” this appears to undermine the “No Agency” base case. It is entirely possible that the costs and benefits quoted in this RIA (and hence the “pecking order” of the various Options) would be unaltered against a base case of “Agency but no DN sale” but it would give a measure of comfort if Ofgem were to consider this before coming to a final conclusion.
- 1.4. The need to address the base case is again clear as paragraph 1.2 goes on to state that the conclusions of this RIA “...will be included in Ofgem’s broader RIA on whether [GEMA] should consent to Transco’s proposed disposal of DNs.”. As the base case is that the sale has taken place with No Agency then the conclusions from the present exercise can’t meaningfully contribute to answering the question of the desirability of sale.

### 2. Objectives

- 2.1. In paragraph 3.8 Ofgem refers to standard condition 4D of the GT licence which requires each GT to ensure that neither it or its affiliates obtain any



unfair advantage from any preferential or discriminatory arrangements. Gemserv believes that will be even more difficult for Transco to demonstrate compliance with this requirement in a post DN disposal industry if it retains its present level of control and influence over the governance arrangements. In this context it would be safer from Transco's viewpoint to have a completely independent governance entity or at least one that clearly operates at "arms length" and is not subject to inappropriate levels of influence by any individual or group of stakeholders.

2.2. In paragraph 3.10 Ofgem refers to its intention to consider the experience of the electricity industry and acknowledges that the industries were structured differently from the outset and hence comparisons should be made with care. As the governance service provider to the electricity retail sector Gemserv has gained valuable experience of the operation of this market and is able to assist in drawing out the lessons learned. Equally, through its experience of the activities and governance arrangements in the gas industry it is perhaps uniquely placed to provide an informed view of which aspects of governance in either industry represent best value and best practice from the stakeholders points of view.

### 3. Key Issues – Accountability

3.1. In paragraph 4.12 Ofgem states that there must be clear allocation of responsibilities as between NTS, DNs and the Agency and that responsibility for any failure to provide quality services is properly defined. Gemserv believes that underlying this statement (and references in 4.15 to the possibility of the Agency becoming a separately licensed and regulated entity) is a potentially dangerous assumption about the nature of the Agency and its relationships with industry stakeholders. If, as is believed, the Agency acts solely as the agent of NTS and DNs (its principals) then responsibility for the discharge of licence and contractual obligations clearly and firmly remains with the principals (NTS and DNs in this case). It must remain the responsibility of the NTS and DNs to retain close control and management of the Agency through which their obligations are discharged. If this principle and that of the Agent being transparent are born in mind it is clear that incentives to ensure that quality of service is maintained/improved can only



be placed on the NTS/DNs who in turn must incentivise the Agency through their contractual arrangements. It is therefore unnecessary to consider adding further layers of regulatory oversight as, in a sense, the Agency is invisible and is “standing in the shoes” of NTS/DNs who always remain accountable for the acts and omissions of their agent. This understanding preserves the possibility of NTS/DNs exercising choice at some point in the future over who to use as their Agent since the services to be provided are set out in licence, Network Code(s) and SPAA and are unchanged simply by introducing xoserve or any other entity through which to discharge them. Conversely if xoserve were to become a licensed and regulated body then introducing competition into service provision would become more difficult if not impossible.

#### 4. Key Issues – Governance

- 4.1. Gemserve welcomes the use of the five principles outlined and, as stated above, believes that if the arrangements are to pass the tests set by these principles and be truly impartial in operation then they cannot be controlled by a dominant player or set of players. It is clear that a Governance Entity independent of undue influence will be required.
- 4.2. In considering “Future Issues” Ofgem acknowledges that work remains to be completed in a number of areas and lists five specific topics to be resolved before any sale could proceed. Gemserve will, as a member of the Agency workgroup, continue to play its part in resolving these issues, however we would wish to comment here in relation to paragraph 4.23 where it is stated that the workgroups should consider the governance of the Agency especially in the light of the objective to reform the Supply Point Administration (SPA) arrangements. This seems unnecessary as the Agency can only act as required by NTS/DNs in discharge of their licence and contractual arrangements and should have no “agenda” of its’ own beyond any incentives placed upon it by NTS/DNs to reduce the costs or improve the standards of service. The contractual requirements and governance arrangements between NTS/DNs and their Agent need not be public provided responsibility clearly remains with the licensed entities. Normal



internal company governance should operate between shareholders, board of directors and management of the Agency. Furthermore it has been understood that reform of SPA is intended to be achieved via the Supply Point Administration Agreement (SPAA) to which the Agency will not and need not be party in its own right in order to continue to discharge DNs Network Code/SPAA obligations.

4.3. In “Issues to be considered at the next price control review” Ofgem makes it clear that there is no intention to alter the existing price control. This means that NTS/DNs will continue to receive revenues from shippers in respect of services provided by both the Agency and the Governance Entity. This seems to imply that Transco will retain full control over the governance arrangements until 2008 at the earliest.

4.4. In paragraph 4.27 Ofgem outlines a risk that without competitive constraints the costs of Agency and Governance Entity would tend to rise whilst quality deteriorated. Provided the issues surrounding pricing can be resolved and each body were independent there would seem to be no bar to making both activities subject to competitive pressures through periodic tendering and/or contract review.

## 5. Options

5.1. Seven options are considered (excluding the “no agent” option). NGT’s original proposal, Option A, is discounted as it would be least likely to pass the tests set out in terms of governance as control would remain with Transco. Option B introduces the concept of a quasi-independent Governance Entity (described as an “unincorporated joint venture between NTS and DNs”) which is a feature of all other Options, specifically to address the concerns surrounding governance under Option A. It is anticipated that use of the Agency and the Governance Entity will be a condition of sale of each DN. Clearly this implies that the cost to NTS and DNs for use of these body’s will be calculated and agreed prior to sale, probably covering the period to the next price control. This leads Gemserv to the view that a “budget” will exist for carrying out the activities of the Governance Entity and that it would therefore be possible to carry out a market testing exercise to



establish if an independent company would be able to provide the services at an acceptable price now rather than waiting for the next price control. If such an exercise established that the Governance Entity services could indeed be provided by an independent company then it would be possible to conduct a tendering exercise in parallel with the sale in which the NTS and DNs (as the budget holders) in conjunction with a panel of industry stakeholders and Ofgem could formulate the contractual requirement and let the contract. This would circumvent the requirement to consider the need for structural and legal separation and make operation more transparent and simpler as there would be no ring-fencing or arms length arrangements needed to ensure impartiality.

5.2. The six remaining Options vary in the scope of work to be undertaken by the Agency with the Governance Entity role being constant in each. The pros and cons of each Option centre chiefly upon the degree of fragmentation and hence additional cost caused by moving centrally provided services out into the separate DNs. In considering these options much thought is given to the degree of “ownership” of computer systems by the Agency in order to prevent fragmentation. It seems logical to Gemserv that the Agency should not have direct ownership of the systems but rather operate and manage them under contract on behalf of the licensed entities who would retain ownership and control. Ownership by the Agency is not only unnecessary but it would serve to make it far more difficult to introduce competition in the role at a later date.

5.3. Ofgem recommends two options (B1 and E) as having significant advantages over the others. The chief differences being that B1 has the activities of “gas nominations ops and settlement” carried out within NTS whereas in E this is located in the Agency, and the activities of transmission and distribution credit and cash collection within Agency whereas in E they are located in NTS and DNs respectively with the systems ownership located with them. As previously observed Gemserv is of the view that the Agency can only provide services on behalf of the NTS/DNs and should not own the industry computer systems itself. In all Options Gemserv believes that the prime responsibility for carrying out each business activity lies with the



principals and not the Agency. The Agency must be controlled and incentivised by its principals with its introduction not in itself requiring any change in the way business is carried on between suppliers/shippers and NTS/DNs. The specification and governance of business activities continues to lie with the Network Code and (increasingly in the future) SPAA and it therefore follows that the Agency role could be expanded to the extent required to avoid fragmentation without necessarily altering the business rules or computer systems beyond any legal requirement to reflect multiple ownership of DNs.

## 6. Summary

6.1. Gemserve supports the introduction of an independent Governance Entity and believes this could be made the subject of competitive tendering in parallel with the DN sale process.

6.2. Gemserve believes that the Agency role should be constructed in such a way that it too can be made subject to competitive pressures and that it would be incompatible to move regulated assets into this entity requiring it to be licenced and regulated. There is no case for the creation of a licenced monopoly business if a competitive solution can be found.