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Dear Sonia,

National Grid Transco – Potential sale of network distribution business:

Allocation of roles and responsibilities between transmission and distribution networks

Agency and governance arrangements

Statoil (UK) Limited (STUK) welcomes the two consultations on the regulatory impact assessments (RIA) that Ofgem have conducted. STUK hope that the current consultations and the continuing work stream process can deliver a solution that minimises both disruption to competitive markets and protects against increases in costs to Shippers, suppliers and end users.

As a member of the Gas Forum STUK have access to the report written by OXERA which the Gas Forum commissioned to inform the debate on the DN sale process. This report, which will be made available to you by the gas forum, highlighted a number of areas that need to be addressed and which have been raised within our response.

One of the strengths of the Oxera report is that it contains costings for the various agency models it considers. These clearly demonstrate that Option Gamma (related to Ofgem option F) clearly offers the least cost option to Shippers/Suppliers.

STUK believe the agency arrangement is key to ensuring the industry retains the benefits of economies of scale and avoidance of the costs of industry fragmentation. It is important to note that the costs of fragmentation impact on Shippers, Suppliers and Transporters. As such any analysis should not only consider the Transporter cost/benefits but the industry costs/benefits as a whole. Failure to perform such quantitive analysis could result in the RIA being inaccurate.

Ofgems analysis suggests a number of failings of Option F. STUK would like to understand the reasoning Ofgem have made to come to these conclusions. STUK believe the only tangible areas of potential increase of costs are around the quality of service. These could be mitigated through licencing, governance and cost controls around the agency arrangements.

The following represents the more detailed points that STUK would like to raise.

Allocation of roles and responsibilities between transmission and distribution networks

- STUK found it difficult to assess the options outlined in this document without reference to the absolute level of costs associated with separation. While we recognise that the purpose was to establish the suitability of options in comparison with each other the absolute cost of this move with associated breakdown of costs for functions would allow greater comparison and analysis, where it was felt that our views may be different from those of Ofgem or Transco.

- The exclusion of loss of economies of scale is not representative of the impact of Independent distribution networks (IDN's) creating their own operation centres. Although the set up costs may be considered within the cost of buying the network and Ofgem can legitimately exclude these costs from any future price controls they are unlikely to exclude ongoing operational costs of each of the control centres. This is clearly an impact of loss of economies of scale.

- It could therefore be argued that Options 2 and 3 have a benefit over Option 1 in that they will retain economies of scale for the operation of the control centres.

- There has been little account of the impact of the contractual complexity of Options 1 and 2 on End users. While Ofgem state that investment signals are better where constraint management and investment are both controlled by the same party. The contractual complexity of an end user contracting for NTS and DN interruption separately may impact the number of parties willing to offer this service.

- Ultimately the structure of the roles and responsibilities of NGT and DNs will have most impact in relationship to shippers with the definition of the communication links and obligations and scope of the role of the Agent.

Agency and governance arrangements

- STUK found the methodology of the qualitative assessment difficult to assess. The use of ticks and crosses to represent strengths and weaknesses does not provide a clear assessment of the best solution. Although option E does have the most ticks net of the crosses other options are close to this but have more positive impacts. It was not clear if this was the method used by Ofgem to determine the best solution.

- While STUK appreciates the need to protect shipper confidentiality when analysing the data submitted in the survey. The indexation does not provide any insight as to the absolute range of shipper costs and it is difficult to know the level of impact these would actually have on the DN sale process.

- Shippers and Suppliers can gain some comfort from Transco's assurance that any IDNs sold would be required to contract to xoserve for at least 5 years thus ensuring continuity and alignment of processes. During this time xoserve would monopolise the agency arrangements ensuring that geographical fragmentation would be unlikely to occur. The Oxera report highlighted the prohibitive cost of fragmentation of the agency role. Without Transporter costs included, the cost to the community of full fragmentation compared to a wider agency was calculated to be £686.5 million pounds. The costs varied between the various models. Consistently however the greater the level of fragmentation within the model the greater the costs to the industry.

- Further comfort could be given to Shippers/Suppliers by formalising the agency role. This could be done through an agency licence and the extension of the term DN's would be required to use joint agency services. A precedent has been set by the Domestic licence condition placed on Suppliers to sign up to the SPAA agreement.

- STUK note Ofgem has considered the present arrangements that apply in the electricity sector. The Customer Transfer Programme has clearly highlighted the huge differences in the reliability of the Change of Supplier (CoS) processes and numbers of queries between the gas and electricity sectors. One large domestic dual fuel supplier publicly revealed it employs roughly ten times the numbers of staff looking at CoS issues for electricity than for gas. STUK would like assurances that serious consideration is given before assuming any benefits of industry alignment.

- Metering – STUK are unsure why this is thought to have such a large impact on the sale process. The DN is no longer required to be meter provider of last resort and we are unsure what role the DN will play in metering competition. Further, many Suppliers have clearly stated they are unwilling to sign any contract that provides novation rights to Transco thus allowing it to dispose of it's assets as part of the DN sale process.

- Connections – The role the agent would play in connections would be one of information conduit. In other words shippers could contact the Agent for connections and this request would be passed on to the relevant DN to contract for the work.

- Ofgem do not accept that there would be significant costs from DNs handling their own credit management process. However, credit is often problematic for new entrants. Acquiring multiple letters of credit could prove difficult for new entrants and may restrict their areas of operation.

- Governance – The governance entity could provide a useful method of ensuring a co-ordinated and independent approach to change management of the Network Code and Transportation charging methodology. However, STUK have some concerns regarding the level of cost and incentives placed on this function. The shape of the Network code and the structure and powers of the Modification panel would be key to any governance entity.

- RGTA/AT Link – While these were separate systems it may be possible to separate them out to sit in different organisations, however, Gemini will mean they are an integrated system and it is not clear how easily they could be separated. STUK would not want any solution that created more systems with which to interface as under option D. This must increase costs for all parties.

- The OXERA report demonstrates that the structure of the Agent, even in its broadest form, would not impact significantly the ability of DNs to make major OPEX and CAPEX efficiencies under comparative regulation[1]. The main efficiency gains come from procurement, outsourcing and asset management, which would not be affected by the scope of the Agency.

Oxera highlight the areas in which Ofgem have previously reported they believe comparative regulation has bought benefits in the Electricity and Water industries are of interest as the assumption seems to have been made that these are areas in which the gas industry has not made savings in the past. They are as follows:

- Procurement and logistics. Transco has been at the forefront in the utility arena in consolidating, rationalising and outsourcing of procurement and logistics functions and has taken advantages of economies of scale to drive down purchasing costs. NGT's latest 'Networking' magazine highlights a pilot scheme they are running in the west midlands to run the logistics functions more effectively demonstrating innovation is still possible despite being a national organisation.

- Outsourcing. Transco currently outsource the majority of their mains replacement activities, IT development and much of their bulk meter replacement programmes. Consideration has also been given to outsourcing other functions such as the emergency call centres.

- Asset management. There have been suggestions that condition based asset managements systems as used in electricity could be used to cut costs. The major difference between gas and electricity transmission assets is that generally transmission assets in electricity are above ground and therefore open to easy inspection whereas gas asset are usually buried. Where conditions of assets are known (such as the NTS) then condition-based replacement has been followed and has been successful demonstrating that Transco has been open to consider different asset management regimes.

- Performance Management. Transco has run performance management schemes with its staff for a number of years and continues to do so.

- New Technology. Transco has embraced new technology in engineering such as live insertion techniques and plastic pipe technology. The water industry has particularly highlighted its use of mobile communications in water metering. The gas

[1] OXERA (2004), Cost and benefit implications of alternative Agency options for sale of DNs

industry has also embraced this technology and many Suppliers are currently gearing up to increase their use of AMR equipment.

- Consolidation, Rationalisation, Integration. The creation of DNs is surely the complete opposite of all of these.

STUK would therefore be interested to understand what other areas Ofgem believe there is opportunity for comparative regulation to drive benefits.

As we have highlighted above STUK would like a number of points clarified regarding the finding of the Ofgem RIA's. In particular we would like to see further discussion of the options and analysis conducted on the benefits of comparative regulation and the advantages associated with option E over a broader agency role as we believe that these have yet to be fully addressed.

STUK welcome the opportunity to comment on this consultation. Should you wish to discuss any of the issues raised in this response with me further please contact me on the above number.

Yours sincerely

Robert Cross
Regulatory Affairs Manager