

POTENTIAL GAS DISTRIBUTION NETWORK SALE

**OFGEM PRELIMINARY POSITION ON THE BUSINESS SEPARATION
REQUIREMENTS TO APPLY BETWEEN DISTRIBUTION NETWORKS**

Introduction

The Offtake Arrangements conclusions document explains that the Gas and Electricity Markets Authority (Authority) is minded to require Transco to undertake targeted structural and legal separation between its National Transmission System (Transco NTS) and Retained Distribution Network (RDN) businesses.¹

A related issue that needs to be considered in the context of the potential sale of Transco's distribution networks is whether business separation requirements should apply between individual distribution networks (DNs) in the event that multiple DNs are under common ownership. In particular, Ofgem has been asked for a view on whether legal separation will be required between DNs.

This issue is of immediate relevance in relation to Transco's RDNs. However, consistent with the creation of a 'level playing field' for the purposes of comparative regulation, in the event that a DN buyer purchases more than one DN, any arrangement with respect to DN-DN business separation would apply equally to RDNs and independent DNs (IDNs).

This paper sets out Ofgem's preliminary position on DN-DN separation. It is supported by a presentation to the Development and Implementation Steering Group (DISG) which was given on 17 August 2004.²

In issuing this preliminary position paper, it is important to make clear that there can be no expectation on the part of Transco, potential DN purchasers or any other interested parties either as to what the Authority's final decision in relation to the proposed DN sales may be, or as to the regulatory framework which may be implemented if the Authority consents to the proposal. This preliminary position paper is provided on an informal basis and should not be treated as binding on the Authority. Nothing in this

¹ *National Grid Transco – Potential sale of gas distribution network businesses, Offtake Arrangements Conclusions document on framework, Ofgem August 2004.*

² This presentation is published on the Gas Distribution Network Sale page of Ofgem's website under the minutes and papers of DISG 16.

position paper is to be construed as granting any rights or imposing any obligations on the Authority. The Authority's discretion in this matter will not be fettered by any statement made in this paper.

Legal separation between distribution networks

If legal separation between DNs was required, each DN would be required to be held in a separate legal entity with its own individual Gas Transporters (GT) licence.

Ofgem has identified a number of potential benefits associated with legal separation between RDN businesses. These benefits relate to Ofgem's ability to regulate DNs going forward.³ For instance, DN-DN legal separation would make the DNs' licences more standard because it would not be necessary to develop area-specific conditions in cases where multiple DNs are subject to a single licence (for example, in relation to price controls). This could help to ensure consistency in approach by Ofgem.

Arguably, a benefit of DN-DN legal separation is that it creates more transparency (for the purposes of setting the price control as there is a statutory requirement for separate accounts. This could enhance Ofgem's ability to make comparisons. However, Ofgem notes that the transparency benefits of legal separation could be undermined if Transco or an IDN adopted an 'operating company' type structure, whereby a number of licensed entities are operated by a service company.

Against these potential benefits Ofgem has carefully considered the potential costs of DN-DN separation. The majority of the costs would fall to Transco, in particular in relation to debt financing and property transfer costs. A number of other potential costs could also arise. For instance, legal separation could potentially give rise to additional operating costs as each licensee would need to demonstrate to the HSE that it has sufficient directing mind to discharge its duties under the safety case. Further, Transco contends that additional resources would be required in relation to company secretariat and governance, accounting and financial management, contract management and general administration. These costs would not be accompanied by any offsetting efficiency improvements through the introduction of independent management teams.

³ In this respect, the benefits of DN-DN separation differ from the benefits associated with NTS-DN business separation, which primarily relate to reducing the risk of undue discrimination by the NTS in favour of RDNs to the disadvantage of IDNs.

Ofgem intends to retain its position on cost recovery as expressed in relation to NTS-DN separation. Whilst Ofgem considers that the costs associated with RDN-RDN business separation requirements should primarily rest with Transco and form part of Transco's decision to sell, it is realistic to acknowledge that if such requirements gave rise to significant additional operating expenditure, then the potential benefits of comparative regulation could be restricted (especially if the efficiency frontier is relaxed). Further, the potential customer benefits of DN sales could be lost altogether if the costs associated with RDN-RDN separation were so great as to dissuade Transco from proceeding with the sale.

When assessing the potential costs and benefits of DN-DN separation, Ofgem has considered the views of the industry workgroup members who have not perceived DN-DN separation as a key issue. In addition, one respondent (other than NGT) to the Offtake Arrangements RIA suggested that it would be unlikely that additional benefits would arise if RDNs were required to separate from each other.

On balance, Ofgem does not support a regulatory requirement for DN businesses to be separate legal entities. Ofgem considers that it is possible to draft licence conditions so as to require the entity which has ownership of the RDNs to ensure that it maintains accounting and reporting arrangements which enable separate regulatory accounts to be prepared for each RDN. Going forward, it will be necessary to design the GT licences in a way that creates a level playing field between all DNs so that the benefits of comparative regulation may be secured.

Ofgem notes that there is currently legal separation between electricity distribution companies. The analysis and conclusions set out in this document should be distinguished from the electricity industry because of historical differences in the manner in which the two industries were privatised, and factors associated with safety requirements.

Structural separation between distribution networks

Structural separation between the NTS and RDNs is one of a number of measures proposed by Ofgem to reduce the risk of undue discrimination by the NTS in favour of its affiliated RDN business to the detriment of IDNs. However, this risk does not arise between DN businesses as DN do not have any significant opportunity to confer a commercial advantage on each other. A requirement for structural separation between

RDNs could have a significant effect on Transco's operating costs, and would be inconsistent with the electricity industry. Consequently, Ofgem's current position is that there should be no regulatory requirement for DN businesses to be structurally separate from one another.

Way Forward

The preliminary position set out in this document is the product of a thorough assessment of the issues, and consideration of views expressed through the workgroup process. In the absence of significant new information, it is unlikely that Ofgem's position will change.

Industry participants have the opportunity to provide written submissions on this issue in the context of the consultation on the proposed grant of eight new additional gas transporter licences to Transco.⁴ However, given that a requirement for DN-DN separation could have a significant impact on the proposed timetable, Ofgem requests that any comments are provided to Tracey Hunt (tracey.hunt@ofgem.gov.uk) by 27 August 2004.

⁴ Notice of this consultation was published on the Gas Distribution Network Sale page of Ofgem's website on 23 July 2004. Submissions on this consultation are due on 24 September 2004.