

27th September 2004

Ms. Sonia Brown

Office of Gas and Electricity Markets (Ofgem)
9 Millbank
London
SW1P 3GE

Dear Ms. Brown,

Re: Restructuring of Transco plc's Gas Transporter Licences

On behalf of ESP Networks Ltd ("ESPN") I wish to respond to the consultation on the restructuring of Transco's Gas Transporter licence in relation to the proposed sale of the DNs.

ESPN's key concern regards the provision by Transco to iGTs of the four main emergency services:

1. The call-center.
2. "Make Safe" service within 30 minutes.
3. Network emergency repair work.
4. Meter repair and replacement service.

These form a critical part of an iGT's operation and so the implications for the iGTs if these services are not provided as a DN licence condition would be serious. Also for Ofgem this must be an important consideration in fulfilling its duties including the service provided to customers, efficiency of iGTs, and undue preference. Although these are highlighted in the consultation document I would also draw your attention to an additional requirement as follows:

"that the modifications are such that no other holder of such a licence would be unduly disadvantaged in competing with other holders of such licences (including the holder of the licence)"

General

When the market was first opened up to competition it was acknowledged by all parties that unless Transco provided a full emergency service to the iGTs no company would be able to operate networks effectively, and so to ensure full and effective competition Ofgem made Transco provide the current emergency services. Since that time iGTs have been operating based on the assumption that this service will remain for the long-term until individual iGTs become sufficiently big enough to employ other companies to do some or all of the work. Currently it is ESPN's belief that all iGTs use Transco exclusively for the first three services and where some may use other parties to carry out meter work they still rely on Transco as a fallback where this cannot be provided on occasions by these parties. With this in mind it

should be noted that the relationship with Transco regarding this service has been problematic at times, to the extent that if there were a viable alternative for any of the four services at least some of the iGTs would have contracted with other companies to carry out the emergency services instead of Transco. As no iGT has not yet done this, and from discussions with the other iGTs it looks unlikely any are in the position to do so, it demonstrates that there is no viable alternative to Transco for “all four” services.

Difference to the DNs

IGTs are very different to the DNs operationally in that DNs will be operating in a defined area where they own the vast majority of the gas networks. This allows them to operate their own services as the amount of work in their area will be sufficient to benefit from economies of scale, thus giving them the ability to take on staff direct and/or contract services out by offering multi million pound contracts to contractors.

IGTs on the other hand have networks spread all over Great Britain which are much smaller than a typical DN with regard to the amount of network both in length of pipeline and number of connections. This firstly does not allow iGTs to take on staff direct to carry out emergency work, and secondly the contractual value of the work is much lower which makes it worse as it will be split amongst different contractors to enable the iGT to get national coverage.

For these reasons it is relatively easy for DNs to operate their own emergency services, and even cater for emergency work carried out on other DN networks close to them when required occasionally. However for iGTs it is far from practical both operationally and financially to provide all aspects of emergency services, therefore iGTs rely almost entirely on Transco to provide the national coverage required.

Distribution of Networks

As mentioned the distribution of iGT networks is all over the country with high density in the urban areas and much lower densities in rural areas. In addition the amount of emergency work required on a typical network is very low, and there may be a period of years where the service is not required at all. This will give iGTs a major problem in getting alternative national coverage as there are, to ESPN's knowledge, no contractors who can cover the whole country therefore it will require iGTs to contract to a number of contractors to ensure national coverage. In addition although the work in the urban areas may get to a level where it is practical for a contractor to provide a service, for rural areas the work will be very little and so widespread contractors will not in practice be able to set up systems to carry out the work effectively.

In addition the level of service contractors will provide in different areas of the country will vary enormously as a fast response would be possible where networks are close to the contractor's depot, however for remote networks contractors could not provide the same level of service to the extent where they would be unwilling to commit contractually to any at all and provide the service on a best endeavors basis.

As a gas transporter who actively develops domestic infill projects I would comment that if ESPN cannot procure a full emergency service (i.e. all four services listed) at an economic rate this will mean many infill projects in rural areas will not be developed. Also even if a service can be procured if it is not at the same level as Transco's, in particular the speedy repair of mains and meter repair/replacement ESPN would view these projects as having a higher level of risk which may make them unattractive to develop. ESPN is particularly concerned with a number of existing projects that it has in quite isolated areas (for example a number in the Highlands of Scotland), and ESPN does not believe there is any other company that can provide it with the four main emergency services. Therefore if any of the emergency services are withdrawn by Transco/DNs, for these networks ESPN believes it may be left with no effective service and even if the make safe service is still provided, if there is an incident requiring repair work these customers may be left with no gas for significant periods of time. (It should be remembered that these areas have heavy snow fall in winter making access very difficult for contractors having to travel significant distances.)

Cost of Alternative Services

If iGTs are able to find contractors to fulfill the emergency services for them, the next issue will be cost. ESPN cannot see any contractor being in the position to provide the services at anywhere near the same prices as Transco even if provided at reduced service levels to take into account any limitations in resources and logistics. This is because Transco has the benefit of economies of scale in that it has sufficient work within each of its areas to ensure the workforce can be employed efficiently. For example it can employ teams local to the area who will have short traveling times and be able to do many call outs in a day. In comparison the amount of iGT work will be so little and unpredictable that any teams employed for an iGT are unlikely to be local to the area and when they do attend an incident it is likely to be the only work they can do for that call out. In addition Transco has already the systems set up in each area to deal economically with their continual workload, this will not be the case for the iGTs' contractors who will have the high setup costs for systems which in some areas of the country will be used only occasionally.

Also there is the hidden internal cost of administrating different contractors for each area, each with different service levels and prices. This will put an extra financial and resource burden on iGTs.

Finally ESPN is sure that there will come a point where the number of networks that a contractor is asked to cover will simply not be commercially attractive for any contractor to want the business. This is particularly likely for the smaller iGTs where they may have only a handful of networks in an area. From experience contractors only appear to be interested in quoting competitive rates for this type of long-term service work where it provides a turnover of about £500,000 a year, and anything below this is not very attractive and is only viable if the contractor increases its margins too much higher levels. Saying that when the value of work goes to very low levels even at high margins the contractor makes so little from the work they would not be interested in the work based on the liabilities and general hassle in providing a service that would be resource intensive. For example if an average of £3 to £6 per connection is spent on emergency cover, if an iGT has say 5,000 network connections in an area this represent to a contractor only £15,000 to £30,000 per year.

RPC and Migration Dates

Currently when iGTs set their transportation charges under RPC, and also when they negotiated migration dates with Ofgem, they base their long-term operating costs in relation to emergency services based on Transco's service provision. Normally a change to a new service provider would not be considered a significant event, as there would be a comparable alternative available. However in this case ESPN expects, where it can obtain the services, the change in charges to be so significant that the economics of the company's operation would be severely adversely affected. This may possible mean that the original economic criteria for legacy and recent networks will no longer be met, which if happens I believe ESPN will not be alone in requesting that the basis which RPC and migration dates were agreed be reviewed.

Problems if Limited to Make Safe

Regardless of the other issues described ESPN has an additional concern regarding how some situations could be handled if Transco/DNs are required to provide a make safe service but do not have to provide any follow up repair work. For example there may be an incident on a mains pipeline feeding a large number of properties, which would normally be dealt with by a bypass being installed to ensure that the gas supply is maintained while the pipeline is repaired (even if it is temporary repair until the iGT's contractor can attend site). However if a repair service is not provided then the network would be "made safe" by clamping off the pipeline to stop the escape of gas until the iGT's contractor can attend site to make repairs. In this situation the premises on the network would have no gas supplies until the repair is done AND there will be a significant extra cost for the iGT to visit ALL the premises to ensure the services are restored safely (i.e. relight pilot lights, etc). In addition the iGT is likely to have to make several visits to the site as access to properties will only be available over a period of time as appointments can be made, this means customers could be without a gas supply for a significant period. This as you can see is far from an ideal situation for both customers and the iGT.

Contractors Able to do the Work

ESPN believes that even if the service to the customer is not an issue and iGTs are willing to pay what ever it costs there will still be some areas of the country where iGTs will not be able to find a contractor able to provide a suitable service. Particularly the make safe service which requires on-site attendance within half an hour.

Also ESPN has found that contractors sometimes have a conflict of interest where they also provide services to Transco. This is because Transco's work usually takes priority therefore ESPN has found that where the workload is particularly high for Transco contractors are more inclined to remove labour from our projects to fulfill their contract with Transco. This is very likely to be a problem as only contractors providing a service to Transco in a particular area will be able to realistically provide emergency services to iGTs, as they will have local teams to do the work.

There have also been occasions where for various other reasons contractors simply do not have the labour to do the work (sickness, teams often change the contractor they work for at short notice, lack of equipment, etc). This often means the service provided cannot be guaranteed at all times. (For example ESPN has had to wait six weeks for some work to be done on a network simply because the contractor employed cannot get the labour to do the work.)

Competitive Issues

ESPN has some concerns over how DN's may treat iGTs as there will be I am sure a strong pressure from the investors to get an economic return from the purchase, particularly if they are at about 20% above the regulatory asset value. I personally cannot see how these investors will be able to make a better return than Transco as although they may be able to make some cost savings, these will need to at least offset the extra costs incurred from a less centralized business, and so to then increase their net profit above 20% appears not to be realistic. Therefore ESPN believes this pressure on the new DN's could possibly lead to anti-competitive behavior which obviously Ofgem is aware of. However I would draw your attention to how this could be done if any of the emergency services are not provided to iGTs. As ESPN believes that a service provided by any other third party will be significantly more than Transco's current prices and also not as good, if a DN is allowed to selectively provide the service as a non-regulated business it can ensure selective iGTs have a competitive advantage. For example if a DN has, or sets up, an iGT business within its own group of companies it could provide this iGT with a significant advantage over its competitors by providing it with an emergency service that benefits from the DN's economies of scale. Because of this the licence conditions must ensure that any emergency (and for that matter any other services) provided by a DN must be available to all iGTs based on the same terms and conditions.

There will also be competitive issues amongst iGTs, as the smaller business will be disadvantaged by their inability to cover as much of the country, and in their negotiating capability in getting the services at the same prices.

Summary

I must stress that the above problems equally apply to the other service requirements provided by Transco therefore even if there were a provision for Transco and DN's to provide the call center and make safe service. If there is no provision for the other two services iGTs will still face serious problems just in operating their gas networks, let alone maintaining the same level of service to customers at anything like an economical cost.

I believe because iGTs have the experience operating as gas transporters they are the best (and some would argue only) people to judge whether any of the Transco emergency services are truly contestable work. Therefore if there is a unanimous agreement amongst the iGT community that all four emergency services are not in practice contestable work, and for any of them to be withdrawn would have a severe financial and operational impact on their business. I believe for Ofgem to take a different view would be in effect ignoring actual working experience of the industry that I believe would require a very in-depth analysis on Ofgem's behalf to prove how all iGTs can in practice replace all four emergency services.

Also where ESPN is able to replace any of Transco's emergency service with an alternative Ofgem will have to accept that there can be no guarantee that the service to customers will be maintained at its current levels.

Finally I would ask Ofgem how it proposes to deal with any iGT who is unable to obtain the services of a third party to fulfill its emergency requirements for some of its networks as required by the licence conditions and the HSE?

Other Issues

In addition to the emergency services ESPN has a number of other issues it would like to comment on:

There is a concern regarding the provision of connections by Transco and DNs' to their networks which could change to the detriment to iGTs. It should be remembered that it was not that long ago that Transco was accused of anti-competitive behavior by making connecting to its network deliberately difficult to retain connection work. With the incentive to extract extra value from their purchase of the DNs the new owners need to be effectively regulated to ensure this practice does not recur.

ESPN believe that it would be preferential if the DNs were restricted to defined geographic areas to ensure they are not able to compete unfairly in other areas by cross subsidizing these activities using their monopoly business. Also within their own areas there must stringent regulation to stop anti-competitive behavior in relation to UIP work and extensions to the network.

ESPN is assuming that DNs will only be able to invest capital in extending the gas network in the same way as Transco currently does, i.e. it is limited to ensure iGTs can compete successfully.

The discount shippers received from Transco for gas shipped to CSEPs is maintained at about the current levels. As any significant reduction in these discounts will firstly mean current iGT networks will become more expensive for shippers than the Transco/DN equivalent prices, and secondly iGTs may not be able to compete for connection work. Also even if iGTs can still invest sufficiently in new housing networks, infill projects will become none economic to develop if the income drops below a certain level.

If you have any queries please do not hesitate in contacting me on 01372 227561.

Yours sincerely,

Robert Wallace
General Manager