EXPLANATORY MEMORANDUM TO THE

GAS ACT 1986 (EXEMPTION) (NO. 2) ORDER 2005

2005 No. 280

1. This explanatory memorandum has been prepared by the Department of Trade and Industry and is laid before Parliament by Command of Her Majesty.

2. Description

2.1 Following the sale of up to four of Transco plc's (Transco) gas distribution networks, this order will allow for the operators of the National Transmission System (NTS) and the distribution networks (DNs) to conduct limited shipper activities. This will ensure that arrangements comparable to those that currently exist between the NTS and DNs, which are currently both owned by Transco plc and are therefore internalised, can be delivered. The exemption allows the operators of the NTS and the DNs to enter into arrangements for gas to be taken out of the NTS and introduced into or taken out of the DNs without requiring a shipper licence.

3. Matters of special interest to the Joint Committee on Statutory Instruments.

3.1 None.

4. Legislative Background

4.1 Following publication of the Office of Gas and Electricity Markets'(Ofgem), conclusions document on the offtake arrangements between the NTS and the DNs post sales, Transco became aware that all of the options considered for offtake arrangements, with the exception of a shipper booking model, would require an exemption from section 5 (1) (c) of the Gas Act 1986 (the Gas Act).

4.2 The Gas Act requires gas transporters (i.e. those involved in transporting gas around GB in pipes) and shippers (i.e. those who buy gas from producers and sell it to users and/or suppliers and who arrange for gas to be transported) to have, respectively, a gas transporter and a gas shipper licence unless they are authorised by an exemption or exception. However, the Act also prohibits the Gas and Electricity Markets Authority, under whom Ofgem operates, from granting both types of licence to any one company. The Secretary of State has the power to grant licence exemptions.

5. Extent

5.1 This instrument applies to Great Britain.

6. European Convention on Human Rights

Not applicable.

7. Policy background

7.1 In line with the Secretary of State's principal objective in the Act, the general policy objective is to protect the interests of consumers in relation to gas conveyed through pipes, wherever appropriate by promoting effective competition. This exemption facilitates Transco's sale of four of its eight DNs as it allows the implementation of particular gas offtake arrangements between the NTS and the DNs, and gas entry and offtake arrangements between the DNs themselves. The Department anticipates that this sale could facilitate competition and improve the efficiency and workings of the gas market.

7.2 The policy intent of an exemption is quite clear. Under current industry arrangements, the NTS / DN and DN/DN interface is internal within Transco. This Order allows the operators of the NTS and the DNs to make arrangements to allow them to continue to meet their current pipeline system security standards in a manner at least as efficient as at present. The exemption is therefore necessary simply to mirror existing arrangements.The exemption, however, is drafted in a way which ensures that while the operators of the NTS and the DNs are exempt from the need to hold a shipper licence, they can only conduct the essential shipper type activities required to enter into arrangements for the offtake of gas from the NTS or introduction of gas into or offtake of gas from other DNs. The proposed exemption will also allow relevant Gas Transporters to arrange for reject and boil-off gas from Liquefied Natural Gas storage facilities to be put into the DNs. Again, this replicates the current situation.

7.3 Under the Gas Act, the Secretary of State, before making any Exemption Order, must consult and allow a minimum of 28 days for representations to be made. The Department received seven representations (Ofgem, Centrica plc, NGT plc, Scottish and Southern Energy plc, Shell Gas Direct Ltd, MGN Gas Networks Ltd, Cheung Kong Infrastructure/United Utilities Consortium). All seven representations accepted that an exemption is required in order for the DN sales process to proceed. Minor amendments have been made where the Department agreed that clarification in the drafting would help parties understand the Order further. A full response document can be found on www.dti.gov.uk/energy.

7.4 The Department consulted the Health and Safety Executive (HSE) on this Order and is satisfied that, as the exemption seeks to mirror existing arrangements, no new gas safety issue arise. There is therefore no need for the Health and Safety Commission to be consulted. The Department is further reassured on this point as the HSE has to approve a safety case for each of the DNs before the sales can proceed.

8. Impact

8.1 A Regulatory Impact Assessment is attached to this memorandum.

8.2 There is no impact on the public sector. An exemption order is a deregulatory measure.

9. Contact

Radhika Sriskandarajah at the Department of Trade and Industry, Tel: 020 7215 5101 or e-mail: radhika.sriskandarajah@dti.gsi.gov.uk can answer any queries regarding the instrument.

Department of Trade and Industry
2 February 2005

Annex to the Explanatory Memorandum to The Gas Act 1986 Exemption) (No. 2) Order 2005

Final Regulatory Impact Assessment (RIA)

To Make A Limited Exemption From The Requirement For A Gas Shipper Licence In Respect of Operators of the National Transmission System (NTS) and the Local Gas Distribution Networks (DNs).

Objective

The policy objective is to protect the interests of consumers in relation to gas conveyed through pipes, wherever appropriate by promoting effective competition.

At present the NTS and the DNs are owned and operated by Transco plc (Transco), a subsidiary of National Grid Transco plc (NGT). An exemption, if granted, will facilitate Transco's proposed sale of one or more of its DNs by allowing the implementation of particular gas offtake arrangements[1] between the gas transmission and distribution networks (i.e. the NTS and the DNs), and transfers of gas between the DNs. The Department anticipates that this sale could facilitate competition and improve the efficiency and workings of the gas market.

These proposals will impact on the gas sector in Great Britain (GB) i.e. in England, Wales and Scotland.

Background

In May 2003, NGT announced that it would consider the sale of one or more of its DNs. In the event of such a sale, Transco would retain responsibility for the operation of the NTS and transfer its retained DNs (RDNs) into another company in the NGT Group. However, a number of additional industry players would also be created, responsible for the operation and management of the remaining independent DNs (IDNs).

Following this announcement, Ofgem (the Office of the Gas and Electricity Markets Authority) initiated a programme of work to explore the potential benefits that such a transaction may have for consumers. Since July 2003 it has:

[1] Offtake arrangements are arrangements between the NTS and the DNs for the removal of gas from the NTS to be introduced into the DN pipeline system. Refer to: National Grid Transco-Potential sale of gas distribution network businesses, offtake arrangements, conclusion document on framework, August 2004, 199/04

- published seven consultation documents which considered various aspects of the sale as well as the policy, and the costs and benefits of the sale itself;
- held an industry workshop;
- undertaken a series of meetings with industry participants; and
- established a number of working groups comprising various interested parties.

In August 2004, NGT reached agreement on the sale of four of its regional gas distribution networks. NGT proposed to sell the:

- North of England distribution network to a consortium led by Cheung Kong Infrastructure Holdings Limited and including United Utilities;
- Wales & the West distribution network to a consortium led by the Macquarie European Infrastructure Fund;
- South of England and Scotland distribution networks to a consortium comprising Scottish and Southern Energy plc, Borealis Infrastructure Management Inc and Ontario Teachers Pension Plan.

During the sales process, in September 2004, Transco became aware that certain aspects of the proposed arrangements would require an exemption from section 5 (1) (c) of the Gas Act 1986 (Gas Act) in order to permit their implementation. The Act requires gas transporters (i.e. those involved in transporting gas around GB in pipes) and shippers (i.e. those who buy gas from producers and sell it to users and/or suppliers and who arrange for gas to be transported) to have, respectively, a gas transporter and a shipper licence (unless they are authorised by an exemption or exception). However, the Act also prohibits any one company from having both types of licence. Section 6A of the Gas Act allows the Secretary of State to grant an exemption from holding a licence. This exemption, if granted, would allow the NTS and the DN operators to enter into arrangements with each other for gas to be taken out of the NTS or introduced into or taken out of the DNs without requiring a shipper licence.

Risk assessment

- If an exemption is not granted there will be a significant risk that Transco's commercial transaction to sell four of its DN businesses will fail. If no exemption is granted and the DN sales process continues on the basis of (i) reconsidering the roles and responsibilities across the NTS and DNs or (ii) reconsidering the arrangements for offtake from the NTS, the transaction timetable would be subject to significant delay. NGT have noted that any significant timetable delays would be likely to jeopardise the transaction.
- If the DN sales process continues on the basis of the "tame shipper" model i.e. an Sub-option C approach (see below), there would be an ongoing risk to the transaction, as this approach could potentially be subject to challenge.

The DN sales process would be likely to result in significant net benefits to customers (both industrial and domestic). As such, if an exemption is not granted, there would be a significant risk that substantial customer benefits would be lost.

Options

In its August 2004 decision document Ofgem considered 4 options[2] which could deliver the necessary offtake arrangements associated with DN sales. The Gas and Electricity Markets Authority decided that option 2 was the one which best delivered their principal objective of protecting the interests of consumers, wherever appropriate by promoting effective competition. However, the offtake arrangements associated with option 2, considered by Ofgem, will require an exemption from the Gas Act (as would option 1 and option 3). For the purpose of this consultation the Department has considered three sub-options that stem from Ofgem's decision to opt for option 2.

Suboption A: no exemption granted

Under Sub-option A, no exemption is granted and so approaches to facilitate DN sales would need to ensure that gas transporters cannot enter into arrangements to offtake or introduce gas in respect of each others gas transportation systems. The only two viable approaches would be to:

- reconsider the allocation of roles and responsibilities to the NTS and the DNs and implement a "passive DN" model such that a single Gas Transporter (i.e. Transco as the operator of the NTS) makes all decisions with respect to the offtake / introduction of gas across the NTS and DNs; or
- reconsider the offtake arrangements, and implement a shipper-led framework for NTS offtake such that shippers arrange for gas to be offtaken/introduced at the NTS/DN interface.

Re-consideration of Roles and Responsibilities

A previous Ofgem consultation[3] described a "passive" option with respect to the allocation of roles and responsibilities between the NTS and DN businesses, where Transco's NTS was assumed to be responsible for system operation, as well as investment and maintenance planning for both the NTS and DNs. However, the majority of respondents to Ofgem's consultation indicated that this option was not desirable.

In addition, the Authority considered that this approach would limit benefits to customers from comparative regulation by restricting the range of activities across which DNs would have the opportunity to reduce their operational costs. Furthermore, it would cause a lack of clarity in

[2] refer to Annex C for a summary for those options

accountability and responsibilities and hence generate a significant level of contractual complexity and potential for disputes. In order to implement this option it would be necessary for Ofgem to re-consult on this matter.

Re-consideration of Offtake Arrangements

A previous Ofgem consultation[4] described an option with respect to the arrangements for offtake from the NTS, which placed a requirement on shippers to determine the amount of NTS exit capacity required by their customers, and book this in investment planning timescales. In addition, this option removed the "1 in 20"[5] security of supply obligation from the DNs, enabling the market to determine the appropriate level of security.

Most respondents to the Offtake RIA stated that they opposed this option, with many expressing security of supply concerns. As a result the Authority concluded that, as part of the DN sales process, a DN/NTS direct connectee led approach to NTS offtake would be more appropriate. Therefore, in order to implement a shipper-led approach, Ofgem would need to re-consult with industry on this matter. Furthermore, the implementation of such arrangements would involve a significant change to the management of gas network capacity, including the removal of the current 1 in 20 obligation, which would therefore require detailed discussions with the Health and Safety Executive (HSE), and subsequent HSE approval prior to implementation.

NGT have indicated that substantial delays to their commercial timetable such as this reconsideration of a shipper led approach may make the transaction undeliverable with the consequential loss of the potential net customer benefits.

Suboption B: exemption granted

Under Sub-option B of this Final RIA, it is assumed that an exemption from section 5 (1) (c) of the Gas Act is granted. This exemption would enable the framework of arrangements proposed by the Authority (Gas and Electricity Markets Authority), following extensive industry consultation, to be implemented and the DN sales transaction able to proceed within NGT's commercial timetable.

The Order includes a condition on information provision, so that the operators of the NTS and the DNs are required to comply with any direction given by the Authority to provide it with information concerning any relevant gas shipping arrangements, in such a manner and at

[3]National Grid Transco-Potential sale of gas distribution network businesses, Allocation of roles and responsibilities between transmission and distribution networks, April 2004.
[4] National Grid Transco – Potential sale of gas distribution network businesses, Offtake arrangements, June 2004.
[5] This obligation requires gas transporter to install capacity which is likely to be insufficient to meet peak aggregate daily demand (given historical weather data) in only one year out of twenty.

such times as the Authority may reasonably require, to facilitate the performance by it of its functions under the Gas Act, the Utilities Act 2000, or the Energy Act 2004.

Sub-option C: " tame shipper" model

Under this "tame shipper" approach, DNs would be permitted to have a separately licensed shipper entity within their group that books capacity on behalf of all shippers offtaking gas from that DN, the "tame shipper". As such, in the event that four DNs are sold by Transco, four or five new tame shipper businesses would be likely to be created: one associated with Transco's RDN business (assuming the legal separation of Transco's NTS and RDN businesses), and one for each of the four independent networks (although if the same consortium buys two DNs as is currently planned, one fewer tame shipper may be required).

In order for this model to work, information flows would need to be permitted between the DN "network" business and the (separately licensed) tame shipper. The requirement for information sharing between the tame shipper and the DN, and the limited activities associated with the role would suggest that office space and back office support services would be shared. In contrast, if the DN group also conducts competitive shipper activities, information separation would need to be maintained between the tame shipper and these competitive shipping activities. The Gas Act, requires separation of shipper/supplier activities and gas transportation activities and this option could be seen to undermine that intent more so than Sub-option B which aims to deliver a narrow exemption for shipping activity for transporters.

Furthermore, this approach may be open to challenge under European legislation, as tame shippers would be treated differently to competitive shipping activities:

- there would be different information separation requirements; and
- tame shippers would have rights to book NTS exit capacity, not conferred on their competitive counterparts.

Business sectors affected

Under each of the different options considered within this Final RIA, business sectors will be affected in different ways.

Under Sub-option A it is assumed that the alternative available for the implementation of DN sales would be inconsistent with Transco's commercial timetable. As such, it is assumed that the transaction would almost certainly fail, and therefore the status quo would remain. Thus Sub-option A would not impact on businesses in Great Britain (GB).

If DN sales proceed successfully under Sub-option B or Sub-option C, then all GB customers, including businesses consuming gas, would be expected to benefit from lower gas bills than would otherwise have been the case.

As shown in Table A1 below, under Sub-option B:

- the net benefits achievable, and hence the benefits to GB businesses consuming gas, would be slightly higher; and
- the probability that these benefits will be realised will be significantly higher, as the risk of challenge will be much lower.

Under Sub-options B and C there would be a change to the structure of the GB gas sector, with the separation of gas distribution from gas transmission, and the sale of four of the eight gas distribution networks. Sub-options B and C will also lead to the shipper and supplier industries and NTS direct connects incurring costs to ensure implementation of the proposed arrangements. The impact of DN sales on NTS direct connects (of which there are assumed to be 64) is assumed to be relatively small. It is assumed that more of the costs will be borne by shippers, (between 20 and 25 shippers will be affected). In addition, the competitiveness of the shipper market may be undermined by the implementation of Sub-option C.

Costs and benefits

It should be noted that, the costs and benefits given below are in general, based upon assumptions made within Ofgem's Final Impact Assessment (IA) and the associated analysis performed[6]. See Ofgem's Final IA for further detail.

Benefits

Sub-option A: no exemption granted

Under Sub-option A, it is assumed that without an exemption (or pursuit of a "tame shipper" approach as outlined in Sub-option C), the only two alternatives for the implementation of DN sales would require reconsidering the roles and responsibilities of the NTS and the DNs such that either: (i) DNs have a more passive role; or (ii) there is the implementation of a shipper-led approach to NTS offtake.

It is likely that neither of the alternative routes discussed above would lead to the acceptable or successful completion of the DN sales transaction. This is because:

- re-allocation of roles and responsibilities would jeopardise customer benefits and require Ofgem to re-consult, with associated timetable delays and risks; and

[6] The main difference between the costs and benefits presented within this Partial RIA, and those presented by Ofgem within its Final IA relate to a difference in the discount rate assumed. In Ofgem's Final IA, a discount rate of 6.25% is assumed. However, this Partial RIA applied a discount rate of 3.5% consistent with Treasury guidelines.

- re-consideration of the offtake arrangements would lead to a significant delay to the commercial timetable, as it would be necessary for Ofgem to re-consult and undertake detailed discussions with the HSE.

As a result, the Department has assumed that, without an exemption, or the successful pursuit of a Sub-option C approach (as discussed below), the status quo will continue, and DN sales will not proceed. Therefore the benefits of Sub-option A relative to the status quo are assumed to be zero.

Sub-option B: exemption granted

If an exemption is granted, then it is assumed that NGT's commercial timetable for DN sales would proceed as agreed.

Quantifying the benefits associated with Option B

The proposed sale of the DNs, should the transaction proceed, would lead to the creation of three additional, independently-owned comparators. DN sales could therefore generate potentially significant benefits by enabling "comparative regulation" to take place between independently owned entities, and therefore:

- provide Ofgem with valuable comparative information as to the appropriate level of costs that an efficiently run regulated gas distribution business should incur; and
- generate greater incentives for improvement amongst DNs, as they will be obliged to catch up with the benchmark efficiency level or else face shortfalls in their allowed revenue compared to their actual costs.

Customers will therefore be likely to benefit, as the allowed revenue of the regulated businesses, and thus the level of charges to customers, will be lower than would otherwise have been the case.

Furthermore, the sale of one or more DNs will result in the introduction of new management into the GB gas distribution industry. This has the potential to increase efficiency savings by:

- generating greater innovation within the industry;
- facilitating the transfer of best practice;
- allowing economies of scope to be captured with other utility networks owned by the same corporate entities; and
- removing the disincentive to adopt efficiency savings that could arise if the adoption of the efficiency saving adversely affects colleagues in other commonly owned DNs.

As such, not only could Ofgem be able to establish the "efficiency frontier", but the efficiency frontier would be expected to shift at a faster rate as a result of the introduction of new

management. This means that allowed revenues, and therefore charges to customers, could fall at a faster rate than would otherwise have been the case.

These benefits to customers of DN sales are estimated at a gross benefit of **£457 million** in present value terms[7], assessed over an 18 year period, i.e. the period to 2022/23. See Appendix 1 for assumptions used in this calculation.

Non-quantifiable benefits of Sub-option B

It is possible that the following additional (and non-quantifiable) benefits would also result:

- promotion of competition in the wholesale gas market: a clear set of offtake arrangements may enable more transparent pricing, improve investment signals and allow more efficient network development over the longer term;
- promotion of competition in the retail gas market may occur through innovative products that retailers can design, enabled by more flexible and responsive DNs; and
- security of supply: the improvement in investment signals may also have positive benefits for security of supply (although security of supply was not used by Ofgem to differentiate between the options considered).

Sub-option C: "tame shipper model"

Should DN sales successfully proceed on the basis of the "tame shipper" model, the same benefits as outlined for Sub-option B above would be realised.

However, as stated above, this approach would involve the creation of two different classes of shippers: tame shippers and competitive shippers. Under the "tame shipper" model, tame shippers would be treated differently to competitive shipping activities as follows:

- there would be different information separation requirements; and
- tame shippers would have rights to book NTS exit capacity, not conferred on their competitive counterparts.

As such, this approach risks a challenge from competitive shippers seeking the same treatment as tame shippers. European legislation states that:

- the distribution system operator "shall not discriminate between system users or classes of system users, particularly in favour of its related undertakings"8; and
- "each distribution system operator … shall prevent information about its own activities which may be commercially advantageous from being disclosed in a discriminatory manner."9

[7] All values are expressed in 2004 prices.
[8] Directive 2003/55/EC of the European Parliament and of the Council, Article 12 (2), June 2003
[9] Directive 2003/55/EC of the European Parliament and of the Council, Article 14, June 2003

Given the risk of challenge to such an approach, Sub-option C is regarded as a higher risk. A challenge of this nature, in a post DN sales environment, would mean the offtake arrangements as implemented would not be sustainable, and it would be costly to institute immediate acceptable arrangements.

Therefore, whilst benefits of the same order of magnitude and nature as those estimated for Sub-option B are theoretically achievable, the probability of achieving these, given the risk of challenge, and hence of consent, is very small.

Costs

Sub-option A: no exemption granted

As noted above, in the Benefits Section for Sub-option A, it is assumed that, under this option, the DN sales transaction will not proceed. As such, whilst no costs would be incurred per se, the customer benefits that could be achieved under DN sales (gross benefits of £457m) would be forgone.

Sub-option B: exemption granted

Quantifiable costs of sales under Sub-option B

If an exemption is granted by the Secretary of State, then it is assumed that the commercial timetable for DN sales would proceed. The costs to the following parties were considered in the event of DN sales:

- shippers / suppliers;
- NTS direct connects; and
- Ofgem and the HSE.

The costs to Transco or to the sold DNs of the sale are not included as they are deemed to be a cost of the (clearly voluntary) commercial transaction which this option would facilitate.

Of the other industry parties affected, the more significant cost impact of the proposed sale arrangements will be borne by shippers / suppliers. This is because, whilst at present shippers / suppliers are only required to interface with a single entity (Transco), in the event of DN sales, such interfaces will become more complex with interfaces with multiple parties required. Whilst the framework of arrangements proposed in the event of DN sales, seeks to mitigate the cost impact of DN sales as far as possible (for example, through the creation of an agency that will avoid duplication and retain a single interface for key activities) some costs will remain.

Whilst some costs will be incurred by NTS direct connects as a result of DN sales, these are thought to relate primarily to an increase in negotiation costs. It has been assumed that the majority of the costs will be borne by their shippers. Furthermore, whilst Ofgem and the HSE may need to increase their resources in a post DN sales world, this increase is not assumed to be significant.

Total costs are estimated to be **£125m** in NPV terms over an 18 year period, discounted at 3.5% in line with the Treasury guidelines. See Appendix 2 for further details.

Non-quantifiable costs resulting from Sub-option B

If an exemption is granted there is a risk that this exemption is mis-specified:

- if the specification of the exemption is too wide, then this could blur the boundaries between competitive and monopoly activities and have a detrimental effect on competition in the shipping market. Furthermore, this could undermine the role of a shipper, and hence undermine the intention of the Gas Act.
- if the specification of the exemption is too narrow, then future arrangements may lack the flexibility to evolve in an appropriate way, and hence the efficacy of future arrangements may be constrained.

It would therefore be necessary, when specifying the exemption, to achieve an appropriate balance between: ensuring sufficient flexibility to allow the appropriate evolution of NTS offtake arrangements, and ensuring that the key role of shippers is preserved, and not undermined in any way.

Sub-option C: "tame shipper" model

Quantifiable costs of sale of Sub-option 2C

In the event that Sub-option C was implemented, Transco would incur additional costs, over and above those associated with Sub-option B, to achieve legal separation between the tame shipper functions and other DN functions. These costs would consist of:

- the up-front costs of implementing the separation, estimated by NGT to equate to circa £0.5m of up-front costs for the five tame shipper businesses created (i.e. £0.1m per tame shipper created); and
- additional business running costs and DN running costs as a result of the Sub-option C approach, estimated by NGT to be £125,000 per annum (i.e. £25,000 per tame shipper).

With respect to the up-front costs of setting up the tame shipper model, the £0.5m of costs estimated represent:

- governance costs associated with Company House filing, board and secretariat;
- set up of regulation and compliance processes;

- operation of staff hiring and physical working environment costs;
- back office processes and systems set up; and
- tax / legal costs.

Ofgem is not proposing to allow the pass-through of Transco's up-front costs and as such Ofgem have not included these costs of £0.5m in their net benefit calculation. This exclusion does not, however, affect the overall cost benefit balance.

With respect to the on-going costs of operating the tame shipper model (over and above a Sub-option B approach), the £125,000 of annual costs estimated represent:

- Board and secretariat;
- financial reporting, licence and compliance systems;
- operational inefficiencies; and
- incremental back office processes and systems costs.

The annual cost equates to a net present value, over 18 years, of **£1.6 million**[10].

Furthermore, the legal separation, and separate licensing of tame shipper activities would impose additional up-front costs on Ofgem over and above those associated with Sub-option B with respect to the drafting of the tame shipper licences. Ofgem has estimated that this would involve up-front costs equivalent to one FTE (assumed to cost £80,000).

With respect to the costs incurred by shippers / suppliers, they would continue to face a single interface with respect to the booking of capacity, however, the introduction of an additional link in the chain may require them to perform greater validation of data. As such, we have assumed that the ongoing costs to shippers / suppliers of implementing the proposed framework, as estimated by Ofgem would be 20% higher than a Sub-option B approach to reflect these increased data validation requirements. Furthermore, the costs incurred by NTS direct connects are assumed to be the same as under a Sub-option B approach. This is because it is assumed that under either Sub-option B or Sub-option C, NTS direct connects would request capacity through the relevant competitive shipper.

The costs estimated to be incurred by Transco and DN operators on an on-going basis, shippers / suppliers, NTS direct connects, and Ofgem are therefore circa **£148 million** (ie £23m more than the costs of Sub-option B).

[10] Applying a discount rate of 3.5% to the 18 year period 2005/6 to 2022/23, and discounting to 2004.

Non-quantifiable costs of sales resulting from Sub-option C

As stated above, it is likely that Sub-option C would be challenged by competitive shippers because, tame shippers would receive differential treatment:

- they would be subject to different information separation requirements; and
- they would have rights to book NTS exit capacity, not conferred on their competitive counterparts.

Even if competitive shippers do not challenge the implementation of Sub-option C, this differential treatment will be likely to have the following adverse implications:

- it could introduce the scope for potentially undue discrimination between shippers, and may therefore represent a potential breach of the statutory and licence obligations of the DNs;
- it could blur the boundaries between competitive and monopoly activities;
- it could undermine the role of a shipper, as envisaged within the Gas Act; and therefore
- have potentially adverse implications for the competitive shipper sector, and for wholesale and retail gas competition in general, offsetting any potential benefits that may have arisen from new offtake arrangements that encouraged pricing transparency and innovation.

Furthermore, it is likely that the Sub-option C model would introduce additional contractual complexity, with associated operation, contractual and legal risks.

The impact of such factors is generally difficult to quantify, and as such, these factors remain a qualitative cost for the purposes of this Partial RIA.

Summary of costs and benefits

Table A1 below provides a summary of the qualitative and quantitative analysis performed for Sub-options A, B and C.

Table A1: The costs and benefits of the sales of DNs under Sub-options A to C (£m, NPV, 2004 prices)

	Sub-option A: no exemption granted	Sub-option B: exemption granted	Sub-option C: "tame shipper" model
Quantitative assessment			
Customer benefits	-	£457m	£457m
Customer costs	-	£125m	£148m
Net customer benefits	**-**	**£332m**	**£309m**
Qualitative assessment			
Minimise risk of challenge	-	-	✖
No undue discrimination between shippers	✓	✓	✖
Maintain competitive / monopoly boundaries	✓	✓	✖
Maintain distinct shipper role	✓	✓	✖
Promote wholesale competition	-	✓	✖

Promote retail competition	-	(✓)	✖

Table A1 above shows that Sub-option B has clear benefits (both quantifiable and non-quantifiable) in relation to both Sub-option A and Sub-option C. The quantifiable benefits stated in this table represent the benefits estimated in the event that DN sales generates three additional comparators, and a discount rate of 3.5% is applied. In the case of Sub-option B, net benefits to customers are quantified at **£332 million**. In its Final IA, Ofgem assumed a discount rate 6.25% and performed further sensitivities with respect to the scale of the benefits achievable and the extent to which such benefits will vary with the number of additional comparators created by DN sales. This analysis found that the net benefits to customers decrease if fewer than four DNs are sold, or fewer than three corporate entities acquire the DNs sold. It should also be noted that the Authority has stated that it would impose a condition in the event that it consents to DN sales obliging Transco to agree to the payment of a compensation safety net if its assessment of the expected costs of DN sales outweigh its assessment of the expected benefits.[11]

Given the calculated net benefits, the Department is minded to adopt Sub-option B, and grant an exemption to NGT as requested. The conditions associated with this exemption are discussed in detail in Annex C of the consultation document.

Equity and fairness

Based on the 2001 English House Condition Survey data, it is estimated that there are some 1.4m gas users in the UK who are "fuel poor" i.e. have to spend at least 10% of their income on heating their home to an adequate level. Any measures that lead to a general reduction in gas bills to domestic gas customers will therefore benefit the fuel poor.

Under Sub-option A, the status quo is assumed to be maintained, and as such, the gas bills of the fuel poor would not be impacted. However, as stated above, under Sub-option B and Sub-option C (if it is implemented successfully), gas bills to domestic gas customers, including the fuel poor, could be lower post 2008 than they would have been in the absence of DN sales. In 2005, there are likely to be one-off costs of £18 million. This is substantially less than £1 per consumer. (The average domestic bill is around £335 a year.) Even though there are some recurring costs, these are much smaller and hence the cost to the consumer also falls. From 2008, the expected benefits begin due to Ofgem's Price Control review and from this point the benefits outweigh the costs of the sales.

[11] Ofgem press release, *Ofgem's work on NGT's proposed gas network sale moves to next phase*, 16 April 2004.

Small firms' impact test

As stated above, implementation of Sub-option A implies retention of the status quo, and as such will not impact on the gas sector, or customers. Thus small businesses will also be unaffected.

Under Sub-option B or Sub-option C (if successfully implemented), there will be an impact on small businesses in Great Britain:

- small businesses in Great Britain are expected to experience lower gas bills than they would otherwise have done had DN sales not proceeded; however
- a small number of gas shipper / supplier businesses (potentially no more than eight) are small firms12 and may be adversely affected by the costs of implementing the proposed framework of arrangements.

Therefore, whilst successful implementation of Sub-option B or Sub-option C would be expected to benefit the majority of small businesses, a small number (less than ten) may be adversely affected by these proposals**.**

Competition assessment

As stated above, it is assumed that under Sub-option A there would be no impact on business sectors in Great Britain as the status quo would be retained.

However, under Sub-option B and Sub-option C (if successfully implemented), the structure of the gas sector in Great Britain would change. As stated above, in the event that DN sales proceed, it is currently anticipated that four gas distribution networks would be sold to four corporate entities (two of which will co-exist within the same corporate group). As such, a national monopoly for gas transmission and distribution would become a national monopoly for gas transmission, and four regional gas distribution monopolies (given the number of completely separate corporate entities as owners). Therefore, whilst gas distribution will remain a monopoly business, the creation of a number of regional comparators will allow the impact of competition to be replicated to a certain extent.

As stated in the analysis of the potential benefits of DN sales above, DN sales could generate potentially significant benefits by enabling comparative regulation to take place between independently owned entities, and therefore:

- provide Ofgem with valuable comparative information as to the appropriate level of costs that an efficiently run regulated gas distribution business should incur; and

[12] As defined in Better Policy Making: A guide to regulatory impact assessment, Cabinet Office, January 2003

- generate greater incentives for improvement amongst DNs, as they will be obliged to catch up with the benchmark efficiency level or else face shortfalls in their allowed revenue compared to their actual costs.

Furthermore, in the event of DN sales, shareholders and financial analysts would have more information with which to infer the relative efficiency of each gas distribution company, and this in and of itself may stimulate companies to make improvements. In a recent report on the water sector by the Competition Commission[13], the Commission stated that the advantages of comparisons in the water industry go beyond the effects of setting price caps at periodic reviews as the regular publication of tables comparing companies with respect to quality of customer service and efficiency stimulates companies (who are concerned about their position in such tables) to seek improvements.

Therefore whilst Sub-options B and C would not generate direct competition, the creation of separate gas distribution comparators would generate incentives for each gas distribution company to out-perform its peers in order that it is viewed favourably, in relative terms, by both regulators and shareholders.

However, as stated above, the specific arrangements proposed in Sub-options B and C, and the extent to which they vary, may lead to a differential impact on wholesale and retail gas competition:

- Sub-option B, if implemented, would potentially have a positive impact on wholesale and retail gas competition:
- a clear set of offtake arrangements may enable more transparent pricing, and therefore promote wholesale gas competition; whilst
- competition in the retail gas market may be positively affected if the existence of more flexible and responsive DNs allows retailers to design more innovative products.
- Sub-option C, if implemented would blur the boundaries between competitive and monopoly activities and undermine the role of a shipper, as envisaged within the Gas Act. As such, there would be potentially adverse implications for the competitive shipper sector, and for wholesale and retail gas competition in general, offsetting any potential benefits that may have arisen from new offtake arrangements that encouraged pricing transparency and innovation.

The above analysis implicitly assumes that Sub-option B, by granting an exemption for DNs to conduct a small sub-set of shipper activities, will not undermine the competitive activities of shippers. The scope of the proposed exemption has been established to achieve a balance between retaining some flexibility for offtake arrangements to evolve in an appropriate way, and preserving the key aspects of a

[13] Competition Commission, Water Merger References made under Section 32 of the Water Industry Act 1991, Competition Commission Guidelines, consultation document, July 2004.

shipper's role, such that this role, and consequently wholesale and retail gas competition, would not, in the Department's view, be undermined.

Enforcement and Sanctions

Ofgem will continue to licence and regulate the downstream gas market and hence the transportation of gas around GB. The requirement that an Order revoking this Order cannot come into force before a date at least 4 months from the date the Order is laid has been removed given that the Secretary of State has a statutory duty to consult on a revocation. If it is proposed that the Order be revoked, the Department of Trade and Industry would prefer to discuss with stakeholders on the necessary period of time needed for representations to be made on a case-by-case basis.

Monitoring and Review

Monitoring and reviewing the order will be part of the on-going regulation of the gas market. However, Transco's Gas Transporter licence will be reviewed in 2011 and this would seem an appropriate time to monitor this exemption.

Responses to Consultation

There were seven responses to the formal consultation in November 2004 although not all made detailed comments on the RIA. **All respondents accepted that an exemption was required in order for the sale of the DNs to proceed.**

A number of respondents pointed out the risk to the commercial transaction if there was a delay or if an exemption was not granted and another way forward was sought. One respondent thought that the net benefits of Sub-Option C were substantially less that given the threat of legal challenge which would terminate the sales process.

One respondent raised concerns over the cost-benefit analysis put forward in this document, which was based on the analysis of DN sales put forward by Ofgem. However, no alternative estimates were offered by the respondent. Ofgem published their final Impact Assessment (IA) of the DN sales for consultation in November 2004. This IA was the result of 18 months work and showed that the net benefit of the sales was positive even in the worst sensitivity case. Ofgem is satisfied that their analysis is through and that the net benefit figures provided are both conservative and robust. On this basis, the Gas and Electricity Markets Authority (GEMA, Ofgem) decided to grant conditional approval to the sales going ahead.

Recommendation

In light of the results of the RIA and the comments from respondents to the consultation, it is recommended that the exemption be granted. This would facilitate the sale of the DNs and, as estimated, will provide a net benefit to consumers.

Declaration

I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.

Signed by

Mike O' Brien

Minister for Energy

Date **5th February 2005**

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Appendix 1

Assumptions for the calculation of the benefits of Sub-option B

In calculating NPVs for the benefits case, the reduction in allowed controllable operating expenditure estimated, assuming DN sales proceed, over and above the status quo arise quantified. These reductions in allowed operating expenditure are assumed to pass directly through into customer charges. The assumptions made in performing this analysis are as follows:

- the 18 year period of the NPV calculation covers the remainder of the current price control period (which is scheduled to end on 31 March 2008) and the three five year price control periods that follow.

- the rate of improvement in allowed controllable operating expenditure that would be set by Ofgem for all DNs in the absence of DN sales is assumed to be 3% per annum;

- the rate of improvement in allowed controllable operating expenditure that would be set by Ofgem for all DNs in the event of the sale of four DNs to three entities is assumed to be 4.12% per annum during the first full regulatory period, 5.16% during the second full regulatory period, and 3.09% during the third full regulatory period;
- as Ofgem is not proposing to re-open the current price control, it is assumed that no benefits will be passed to consumers within the current price control period;
- if DN sales proceed to the current commercial timetable, licences will be transferred to new DN gas transporter licensees at the end of April 2005. At this point, the HSE will then be able to review the DNs' safety cases. Once HSE has accepted the appropriate DN safety cases, NGT will be able to proceed towards completing the sale. DN sales may therefore take effect from the end of May 2005 onwards. The modelling works on a financial year basis, and as such, has assumed that DN sales will take effect from 1 April 2005. Though this does not fully reflect the current commercial timetable, the impact on the cost benefits calculation is negligible, and represents a conservative approach as costs are assumed to be incurred sooner whilst in either case, the benefits are not realised until 1 April 2008;
- allowed controllable operating costs from the period to 31 March 2007 are defined to be consistent with the levels allowed upon separation of Transco's distribution price control14 i.e. allowed operating expenditure net of network rates. These costs have

[14] Ofgem, Separation of Transco's distribution price control, Final proposals, June 2003, Table 2.3.

been inflated to 2004 prices, and a further adjustment has been made to net off costs associated with common “agency” services; and

- in line with Treasury guidelines, the Department has applied a discount rate of 3.5% to calculate the NPV for anticipated quantifiable benefits of this option.

Appendix 2

Assumptions for the calculation of the costs of Sub-option B

In August 2004, Ofgem developed and distributed a pro forma to all gas shippers / suppliers requesting an estimate of the additional costs that they would expect to incur due to the implementation of the proposed framework of arrangements in the event that DN sales proceed. Overall, respondents to this information request accounted for approximately 21 million supply points which equates to over 99% of the market, and translates into:

- over 99% of the domestic market;
- 81% of the I&C market; and
- 49 out of the 64 existing NTS direct connects.

Having due regard to these responses, and given its assessment of the costs imposed on NTS direct connects Ofgem and HSE, total costs have been estimated to be circa **£125 million** in present value terms[15], assessed over an 18 year period, i.e. the period to 2022/23. This is calculated by application of the following Ofgem assumptions and analysis:

- Ofgem performed clustering analysis, and excluded outliers on this basis to reflect the significant range of estimates provided; furthermore
- although respondents to the pro forma made up over 99% of the gas shipper market, Ofgem considered that some extrapolation of the figures obtained was necessary. Ofgem therefore assumed that the costs incurred by the second lowest cost respondent were representative of the costs of a non–responding shipper, and that there were eight non-responding shippers16;
- each of the 64 NTS direct connects have been assumed to incur costs associated with the negotiation of contracts equal to £2,000 a year per NTS direct connect17;
- up-front costs to Ofgem of £500,000 as well as two additional regulatory employees (at a cost of £80,000 per annum each) are assumed; and furthermore
- up-front costs of £200,000, are assumed to be incurred by the HSE in approving the safety cases for the DNs.

Again, in line with Treasury guidelines the Department has applied a discount rate of 3.5% to calculate the NPV of anticipated quantifiable costs for this option.

[15] All values are expressed in 2004 prices.
[16] Above a de minimus size i.e. serving over 20 supply points.
[17] In performing its analysis, Ofgem assumed that were NTS direct connects to incur higher costs than those estimated above, that these would be offset by an equivalent reduction in shipper / supplier costs to avoid unnecessary duplication.