



National Audit Office

**THE OFFICE OF GAS AND ELECTRICITY MARKETS**  
Sale of gas networks by National Grid

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## EXECUTIVE SUMMARY

**1** Gas bills have continued to rise sharply in 2005. This report looks at major developments in the regional gas distribution networks that have the potential to reduce gas bills in the longer term. On 1 June 2005, National Grid plc sold four of the eight regional distribution networks for £5.8 billion (**Figure 1**). For a domestic customer, the cost of gas distribution amounts to approximately £80 a year, which represents about a fifth of the average gas bill.<sup>1</sup>

**2** The companies operating the gas distribution networks are licensed so that the interests of customers and the wider public are protected. These licences are issued, modified and enforced by the Office of Gas and Electricity Markets (Ofgem), which is the regulator of the gas and electricity industries in Great Britain. Ofgem operates under the direction and governance of the Gas and Electricity Markets Authority (GEMA), which takes all major operational decisions and sets policy priorities. National Grid needed the approval of GEMA to dispose of the assets which comprised the local gas networks. Ofgem's role was to advise GEMA on whether the disposals should proceed. The test used by Ofgem was that there should be no detriment for consumers. National Grid also required the approval of the Department of Trade and Industry (DTI), and the Health and Safety Executive (HSE) which has lead responsibility for safety implications.

**3** In making its recommendation, Ofgem's primary statutory responsibility was to protect the interests of consumers. Its main tasks were to:

- evaluate the costs and benefits of the sales to assess the implications for consumers;
- work with the gas industry to develop commercial and operational arrangements to support multi-ownership of the distribution networks; and
- identify and address future risks.

**4** The disposals have resulted in the biggest change in the structure of the gas industry since privatisation in 1986 and the de-merger of British Gas plc in 1997.<sup>2</sup> The primary change has been the replacement of National Grid's monopoly ownership and control with a series of contractual relationships between independent companies. To meet its responsibilities, Ofgem had to undertake a number of significant tasks and spent £2.5 million on this work in 2004-05, making this its second largest project in that period.

**5** Ofgem's involvement did not end with completion of the sales. It is seeking to maintain a stable regulatory framework which provides strong incentives for regulated companies to achieve efficiency savings and make appropriate investment in infrastructure, whilst ensuring that they can finance their activities to meet demands for gas.

<sup>1</sup> Gas distribution represents the second largest element of the gas bill, after the cost of the raw product which accounts for one half of costs.

<sup>2</sup> In February 1997, British Gas plc de-merged to form Centrica plc, which focussed on the retail aspects of supplying gas; and BG plc, which included the transportation and storage business.

**1** Ownership of the gas distribution networks in Great Britain from 1 June 2005



- Sold by National Grid**
  - Scotland
  - South of England
  - North of England
  - Wales and the West
- Retained by National Grid**
  - North West
  - West Midlands
  - East of England
  - London

Source: National Audit Office

**6** Against this background, we examined whether Ofgem was fulfilling its duties in relation to the sales. The Report is structured around Ofgem’s role in approving the disposal of assets by National Grid (Parts 1 to 3); and its approach to protecting the consumer interest after the sales (Parts 4 to 6). We gathered evidence from an analysis of Ofgem papers; a survey of the gas industry; discussions with stakeholders; and an evaluation of the financial and regulatory aspects of the sales. We appointed economic consultants, Oxera, to support us in our analysis. Appendix 1 sets out our scope and methodology in more detail. Extracts from Oxera’s report are at Appendix 3.

## Our findings

### Customer benefits

**7** Ofgem concluded that the potential benefits to customers from the sales were most likely to be **£325 million over the period 2008 to 2023**.<sup>3</sup> This should mean lower prices of approximately £1 per domestic customer per year, a small saving when compared to increases in gas bills since 2003.<sup>4</sup> The benefits were expected to result largely from lower transportation charges for using the gas distribution networks. The assumptions used to calculate costs and benefits were well-evidenced and subject to some sensitivity analysis. Ofgem’s analysis of the potential benefit, which was a conservative estimate, gave it confidence that the consumer interest would be protected and formed the basis of its recommendation to GEMA to approve the sales.

**8** The sales will help Ofgem to regulate the gas distribution sector more effectively. The existence of three new operators in the gas distribution sector will allow a better comparison of costs and performance across the networks. Such comparisons will enable Ofgem to set more challenging efficiency targets at future price control reviews.<sup>5</sup> This approach, known as comparative regulation, is well-established and benefits have been seen in the electricity and water sectors.<sup>6</sup> Having new, independently-owned companies should also give rise to innovative and more efficient working practices. On the basis of a review of other regulated industries, Ofgem estimated that the additional comparators would result

3 Ofgem calculated costs of £100 million, resulting in a net benefit to customers of £225 million. Ofgem’s calculations show that the net benefits could be as high as £500 million or as low as £80 million.  
 4 In 2005 average domestic gas bills were £435, an increase of £111 (36 per cent) since 2003 due primarily to the higher cost of gas.  
 5 Price controls are used to set the revenues of regulated companies. Ofgem will now be able to set the revenues that networks can recover (through customer charges) on the basis of the costs of the most efficient performer.  
 6 Ofgem reports that its ability to compare different companies’ performance has enabled it to halve electricity distribution charges in real terms since privatisation in 1990.

in an average 1.13 per cent per annum reduction in the operating expenditure of network owners between 2008 and 2023. This equated to the potential customer benefits of £325 million, and represented the incremental value of comparative regulation.

**9 There is the potential for much larger customer benefits.** The objective of Ofgem's analysis was to estimate the potential for customer benefits arising as a result of sales. To calculate these benefits Ofgem had to make assumptions about the scope for efficiency savings in the gas distribution sector under the no sale scenario. It assumed that the most likely rate of improvement if the sales did not take place was an average annual reduction in operating expenditure of 3 per cent.<sup>7</sup> Our analysis shows that this equates to cost savings of £830 million across the gas distribution sector, bringing the total potential savings to £1.2 billion between 2008 and 2023.

**10 The predicted benefits are subject to uncertainty.** The benefits are forecast over a long time frame, whereas the costs of restructuring are already being incurred by the industry.<sup>8</sup> It is possible, therefore, that the disposals could lead to higher costs before the predicted efficiency savings are passed on to customers. The difficulties faced by Ofgem in securing customer benefits include:

- the inherent uncertainty of achieving benefits over a period as long as 15 years;
- the ability of the companies to find ways to deliver cost savings; and
- the dependence on competitive conditions in the energy market to ensure that savings in operating expenditure by the gas distribution companies are passed through to suppliers, and then on to customers via lower prices.

**11 The effectiveness of comparative regulation is largely dependent upon the quality of information available to the regulator.** Ofgem cannot, itself, deliver the customer benefits but must rely on the behaviour of the network owners. Its role is to create a robust regulatory framework that has incentives to encourage efficient behaviour. Ofgem has established clauses in the licences of the new operators to collect consistent data and is identifying the new information it needs to make effective comparisons between companies. It has also extended the existing gas distribution price control period

by one year to provide a full year of company data before the next price control comes into effect in 2008. These measures are intended to provide Ofgem with a sound basis to conduct comparative analysis of the networks. The availability of sale-related information and historical data on the regional networks should also enable Ofgem to set challenging efficiency targets in 2008 to secure customer benefits during the next price control period. Ofgem has predicted, however, that 80 per cent of the potential customer benefit arising from independent ownership (i.e. £325 million) will come after 2013, as its information on the networks is refined.

### Ofgem's role in the sale process

**12 Ofgem clarified its role during the sales.** In March 2004 Ofgem decided that it would recommend the approval of the sales if they did not result in a net detriment to customers. This stance was consistent with legal advice obtained by Ofgem on the scope of its statutory objective to protect the consumer interest, but differed from an earlier commitment to maximise consumer benefits. Ofgem established appropriate working relationships with the DTI and the Health and Safety Executive, which also had to provide their approval for the sales.

**13 Ofgem completed all necessary tasks before the networks were sold.** The new commercial and operational arrangements that enabled the disposals to proceed have, to-date, been working well. These tasks were completed against the background of a challenging context. For example, Ofgem had to: limit its initial involvement when National Grid announced its decision, to avoid prejudicing the sale process in any way; complete its tasks within the constraints of a commercial timetable; and deal with a seller and prospective purchasers whilst considering the implications for the remainder of the gas industry and the consumer.

**14 This was a challenging project for Ofgem.** There were a number of strengths in Ofgem's approach to managing its input, notably it had a sound understanding of the complexities of the sales; and the project team showed drive and determination to complete the tasks in the time available. There are also lessons to be learnt. The project team was under constant pressure as there were insufficient staff with the necessary expertise, which led to

<sup>7</sup> Ofgem's best estimate was marginally tougher than had been historically achieved by National Grid.

<sup>8</sup> One-off costs were estimated at £25 million, with annual costs of £7 million per annum.

consultants being reappointed without retendering.<sup>9</sup> There was also uncertainty within the industry over the project timetable, despite Ofgem's efforts to seek clarity. Ofgem faced difficulties throughout the project in reconciling the regulatory aspects of the sales with National Grid's commercial timetable. For example, in November 2003, Ofgem delayed the sales timetable to ensure sufficient time for full analysis and consultation on the impact of the sales on consumers' interests. The industry faced a large burden of consultation and many gas companies were concerned that Ofgem added complexity and costs by unnecessarily including a separate project in the sale process.<sup>10</sup>

## Future risks

**15 The prices paid by the three purchasers represented a 10-14 per cent premium to the regulatory asset value.**<sup>11</sup> Ofgem does not believe that sale prices for licensed businesses have any future regulatory implications as it has established procedures for protecting consumers if companies get into financial difficulty and it can capture efficiency savings for consumers at future price controls. In this case, the prices paid were in line with the premiums in other disposals in UK utility sectors over the last five years. As Ofgem's role was to protect the interests of consumers, rather than maximise consumer benefits, Ofgem did not consider that there were grounds to re-open the existing price control as part of the sale process (paragraph 12).

**16 There are a number of valid reasons why purchasers are prepared to pay a premium for regulated assets.**<sup>12</sup> Public statements by National Grid and the purchasers have indicated that the new network operators expect to deliver significant efficiency savings. Ofgem's

cost benefit analysis also assumed that there was potential for additional cost savings (paragraph 9). This raises the question of whether Ofgem could have set National Grid tougher targets at the 2002 price control to secure a larger share of these potential savings for the consumer. Our analysis has not, however, provided evidence of a soft settlement in 2002. Ofgem believes that the separation of National Grid's gas distribution price control into eight regional controls in 2004 was an essential first step in the process of setting future price controls that will deliver larger savings for consumers.

**17 The new owners have a range of financial structures.** There has been a trend across regulated sectors over the last five years for companies to fund capital investment programmes with debt financing, thus increasing the level of debt in their capital structures. Ofgem acted to ensure the consumer interest was protected by reviewing the financial strength of prospective purchasers. It also concluded that its regulatory framework to protect consumers in the event that the network owners experience financial problems was adequate. The longer-term implications of higher levels of debt in regulated companies are, however, unclear and Ofgem is researching the implications to ensure that it is able to respond promptly and appropriately to any risks.

**18 All network owners take safety seriously.** The HSE has lead enforcement responsibility for the safety of the gas distribution networks and has put arrangements in place to seek to minimise public risks. All prospective purchasers had to prepare a safety case, which required HSE acceptance before the disposals proceeded. HSE has also introduced an enhanced programme of safety audits to ensure the new owners comply with their obligations.

<sup>9</sup> In January 2004 a contract was let to PA Consulting, after competitive tender, for a maximum value of £187,000. A number of extensions were approved in 2004 and 2005 to complete additional work. Final outturn is expected to be £1.3 million.

<sup>10</sup> Ofgem introduced a major change to the way the capacity of the National Transmission System is allocated (see paragraph 2.16).

<sup>11</sup> Regulatory asset value is Ofgem's assessment of the asset value.

<sup>12</sup> Sale premiums are likely to be due to a combination of factors, including expectations of outperforming regulatory assumptions; economies of scale; and the advantages offered by more efficient capital structures.

## RECOMMENDATIONS

**19** Our examination found that Ofgem had successfully fulfilled its duties in relation to the sales, which have the potential to deliver customer benefits (paragraph 7). There are a number of lessons to be learned from Ofgem’s achievements, together with actions that should be considered in the future. Our recommendations are intended to highlight these lessons to assist Ofgem when similar developments arise again and help secure the predicted benefits. They will also be helpful to other regulators.

### On calculating customer benefits:

- a** The costs of each option, and the method of calculation, should be presented transparently to the industry, without compromising confidentiality.
- b** Predicted savings based on theoretical assumptions should be tested to understand the practical measures that might be taken.
- c** When setting future price controls for the gas distribution networks, the options for changing the length of the price control period should be explicitly considered to ensure that customers receive the potential benefits of the sales promptly.
- d** The principles of good information management should remain a priority when collecting the data needed to set robust price controls, without imposing undue costs on the industry.

### On the internal management of projects involving sales and mergers:

- e** As a matter of best practice, when a commercial transaction with regulatory implications arises, Ofgem should clearly specify at the outset the regulatory tasks involved. The regulatory activities should not be compromised by the commercial timetable but, at the same time, the regulator should work expeditiously to ensure it does not compromise the effective working of the markets.

- f** Detailed project planning should be supplemented with a comprehensive strategic framework that sets out the issues, risks, priorities, resourcing and timetabling. This should clarify Ofgem’s role and the scope of its work.
- g** A project plan should be published at the outset setting out the regulatory requirements, and the industry kept informed as it is updated in the light of progress.
- h** The method and timing of consultation should be considered – making use of innovative approaches and co-ordinating, as far as possible, across Ofgem – to help interested parties make meaningful responses on each occasion.
- i** There should be optimal use of organisational expertise and experience, and procedures for integrating the knowledge provided by consultants. Ofgem should also consider the scope for sharing expertise between regulators on disposals and mergers.
- j** The fees paid to consultants should be properly controlled.

### On protecting the consumer interest in the future:

- k** Ofgem should continue to monitor developments to ensure that the existing measures for protecting consumers from financial mismanagement in regulated companies are adequate.
- l** The price paid for regulated assets should be considered as it provides a useful source of information about the market’s perception of the value of the regulated company.
- m** Ofgem and other regulators should continue their research into the regulatory implications of gearing in order to ensure a timely and proportionate response to any emerging risks.