House of Commons

Committee of Public Accounts

Gas distribution networks: Ofgem's role in their sale, restructuring and future regulation

Fourth report of the Session 2006-07

Report, together with formal minutes, oral and written evidence

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The Committee of Public Accounts

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The Reports and evidence of the Committee are published by The Stationery Office by Order of the House. All publications of the Committee (including press notices) are on the Internet at http://www.parliament.uk/pac. A list of Reports of the Committee in the present Session is at the back of this volume.

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The current staff of the Committee is Mark Etherton (Clerk), Christine Randall (Committee Assistant), Emma Sawyer (Committee Assistant), Oliver Denton (Secretary), and Luke Robinson (Media Officer).

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Contents

Summary

In June 2005 National Grid sold four of its eight regional networks for distributing gas for £5.8 billion. The Office of Gas and Electricity Markets (Ofgem) is the regulator of the gas and electricity markets in Great Britain and was responsible for approving the sales. Its primary statutory duty is to protect the interests of consumers. It concluded that the potential benefits for customers from the sales were likely to be £325 million over the period 2008 to 2023. This sum equates to approximately £1 per customer per year, a small saving when compared to average domestic gas bills of £550 per annum. The challenge facing Ofgem is to regulate the market robustly to secure early benefits for consumers.

Ofgem's estimate of potential customer benefits represents a modest target. The savings of £325 million are the estimated effect of Ofgem's new ability to compare the costs and performance of four independently owned companies. But, in addition to these savings, it estimated there was potential for further cost savings of £830 million, regardless of whether the sales took place.

Ofgem predicted that 80% of the £325 million would come after 2013 but is not confident that the benefits will be achieved. It therefore needs to set challenging efficiency targets at the next price review in 2008 to deliver savings as early as possible. Ofgem has begun to collect the information needed to inform its analysis. The availability of historical data and information produced by National Grid for prospective purchasers should strengthen its negotiating position.

Ofgem did what was necessary to enable the sales to proceed. A small project team had to oversee a significant re-structuring of the gas industry whilst working within the constraints of a commercial transaction. But Ofgem also made the project unnecessarily complex and placed a large burden of consultation on the industry.

On the basis of the C&AG's Report,[1] the Committee took evidence from Ofgem on: its approval of the sales; the approach to setting prices for the gas networks; and its role in overseeing the infrastructure of the gas networks.

1 Report by the Comptroller and Auditor General, The Office of Gas and Electricity Markets: Sale of Gas Networks by National Grid (HC 804, Session 2005–06)

Conclusions and recommendations

1. **Ofgem approved the sales on the basis that they did not result in a net detriment to consumers, rather than because they would bring benefits to consumers.** Ofgem should take a less restrictive view and focus on getting the best deal for consumers, which is its primary statutory duty.

2. **As part of its sales approval process, Ofgem introduced unnecessary additional changes to the way gas networks operate.** Ofgem subsequently decided to defer these reforms, known as gas exit reforms, until at least September 2007. On future projects, it should be confident that its proposed tasks are central to the fulfilment of its objectives and, therefore, that the regulatory burden imposed on the industry is justified.

3. **The project team launched 13 consultations and 387 documents within 16 months, thus placing a heavy consultation burden on the gas industry which struggled to respond.** Ofgem should explain the full consultation burden at the outset of projects and minimise burdens by co-ordinating the methods and timings of consultation—for example, by using workshops to engage more directly with stakeholders and by grouping separate documents from across the organisation.

4. **Ofgem did not evaluate fully the range of sale outcomes.** Ofgem evaluated the costs and benefits of the proposed sales, assessing the impact of the number of networks sold and variations to the timing of cost savings. But it could have improved its analysis by modelling whether each of its assumptions was realistic in the light of experience. Ofgem's cost-benefit analysis needs to be consistent with the Treasury Green Book and, in particular, the likelihood of different scenarios needs to be assessed.

5. **Before the sales, Ofgem had no independent source of information to benchmark whether National Grid was efficient.** It was, therefore, difficult to regulate the company effectively and set stretching targets to reduce costs.

6. **There is the potential for cost savings of £830 million across the gas networks between 2008 and 2023.** Ofgem calculated that there was the potential to operate the networks more efficiently regardless of whether the sales proceeded. It should make clear to the owners of gas networks that it intends to set a challenging price control in 2008, using efficiency savings of at least 3% per annum as a starting assumption.

7. **Ofgem's ability to bring forward the delivery of benefits is dependent upon the quality of information it collects on the performance of the network owners.** Having several comparators is only beneficial if Ofgem is able to establish clear, reliable and comparable data. It should target its approach to information gathering, focusing on cost and performance.

8. **Ofgem expects that 80% of the consumer benefits arising from independent ownership will come after 2013.** With rising energy prices, consumers need to see the benefits of the sales well before then. Ofgem therefore needs to establish coherent

and reliable datasets as a priority, if possible using comparative information for the 2008 price control.

9. **Ofgem delayed the next price control until 2008, thereby deferring the possibility of bringing early benefits to consumers.** It should consider more carefully the costs and benefits of extending the future duration of price controls by quantifying the consequences of such decisions in terms of the likely impact on prices.

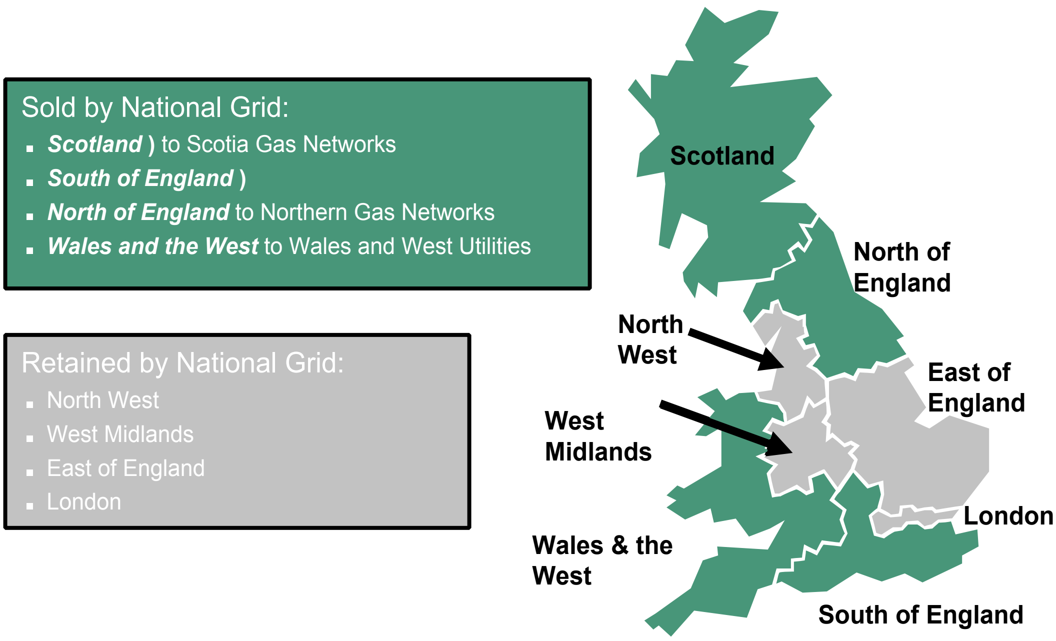
10. **Past capital expenditure on the networks has led to problems with reliability, and 39% of the gas network needs to be replaced** Ductile iron pipes introduced in the 1970s are vulnerable to corrosion and hence leakage. Ofgem should ensure that future capital expenditure is incurred by the network owners on the basis of costs over the whole life of the relevant asset, and not just the up-front capital cost.

1 Ofgem's approval process for the sales

1. Gas suppliers purchase gas from producers and sell it on to consumers. The gas is physically transported across Great Britain by gas distribution pipelines.[2] Until June 2005, these gas distribution pipelines were owned by one national company, National Grid plc.

2. On 1 June 2005, National Grid sold four of its eight regional networks for distributing gas for £5.8 billion **(Figure 1)**. The new network owners now distribute gas to about 10 million customers, while National Grid continues to serve 11 million customers.[3].

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



Source: NAO

3. The gas market is regulated by the Office of Gas and Electricity Markets (Ofgem), whose primary statutory duty is to protect the interests of consumers, wherever appropriate by promoting effective competition. Its secondary duties include promoting the efficient use of gas and ensuring that gas licence holders are able to finance their activities.[4]

4. Since 2003, average domestic bills have increased by around 40% to £550 a year. This includes around £80 a year, about one sixth of the average gas bill, to cover the costs of gas distribution.[5]

2 C&AG's Report, paras 1.1–1.2

3 C&AG's Report, para 1.3

4 C&AG's Report, Figure 5

5 Q 88

Ofgem's role

5. National Grid needed the approval of Ofgem to dispose of the four regional gas networks. Ofgem originally intended to use the opportunity to maximise consumer benefits. But following legal advice on its role in respect of the transfer of assets under a licence condition, it decided to approve the sales provided there was no net detriment to consumers. The advice was specific to the unique circumstances of this deal.[6].

6. This was a challenging project for Ofgem. The sales have led to the most significant restructuring of the gas industry since British Gas split itself into two companies in the 1990s, and involved sensitive commercial negotiations between National Grid and the buyers.[7] Ofgem's tasks were to evaluate the impact for consumers; develop new commercial and operational arrangements; and address future risks. Ofgem spent £2.5 million on this work in 2004–05, making this its second largest project.[8].

Resources

7. Ofgem had plenty of advance warning about the sale. National Grid first approached Ofgem about the proposed sales in January 2003, five months before the formal announcement. Ofgem was able to complete all of its tasks in time for the sales to proceed in June 2005.[9].

8. There are, however, lessons to be learned. The project team did not have sufficient staff with the necessary skills and experience. Ofgem believes it is properly staffed for its normal business but not for one-off projects, including commercial transactions which require specialist expertise in corporate finance.[10].

9. To compensate for the lack of in-house resources, Ofgem made extensive use of consultants. PA Consulting was appointed after competitive tender on a contract worth £187,000. Costs rose to £1.3 million as Ofgem extended the contract, without re-tendering, to ensure the timely delivery of its tasks.[11] Overall, however, Ofgem has reduced its operating costs over the last three years, with consultancy expenditure falling from £8 million to £6 million.[12]

10. To meet its statutory responsibilities, Ofgem needs to recruit and retain skilled staff. It is currently running 10% below its staff complement and has faced difficulties in recruiting senior management staff. Ofgem operates within the Whitehall pay structure whereas other regulators, such as Ofcom and the Financial Services Authority, have more discretion to determine their own pay structures.[13] Ofgem's more limited discretion reflects its status

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6 Qq 1–2, 74

7 C&AG's Report, para 13

8 C&AG's Report, paras 3–4

9 C&AG's Report, paras 13, 2.1

10 Qq 24–25, 77

11 Q 77, C&AG's Report, para 2.7

12 Q 23

13 Q 24; Ofgem Annual Accounts 2005–06

as a non-ministerial government department, whereas Ofcom and the Financial Services Authority are statutory corporations.

Project management

11. Ofgem's project plan identified four key tasks that needed to be resolved before it could approve the sales, including the introduction of new commercial and operational arrangements to support the multi-ownership of the networks.[14] These tasks were successfully completed. But Ofgem made the sale process more complex than necessary. It initially regarded reform of the arrangements for allocating gas capacity on the transmission system as a pre-requisite for the sale but, in January 2005, decided to defer implementation until 2007.[15]

12. The complexity of the issues led to a heavy burden of consultation for the industry. Ofgem issued 13 consultations in a 16 month period, including four in two months in the summer of 2004. Companies acknowledged the efforts made by Ofgem to consult, but were stretched to respond in the timescales allowed.[16]

13. Nevertheless, Ofgem's work was welcomed by most participants in the industry, who felt it had a good grasp of operational issues. But its planning could have been improved in two ways. First, the project timetable could have been made clearer to the industry. Second, it did not identify all the relevant tasks at the outset. This meant that some work, such as the licence changes, could have been started earlier and the need to grant exemptions from the Gas Act was overlooked. There were also unexpected additions for the sale participants. For example, a letter of comfort was requested in the week before sale completion.[17]

Analysis of consumer benefits

14. Ofgem analysed whether the sales would benefit consumers, in order to inform its decision to approve the sales. It saw the main benefit as coming from its ability to compare the efficiency of several similar companies. It therefore estimated efficiency gains that would arise from having such comparators.

15. These estimates were based on a cost-benefit analysis which, in most respects, complied with Treasury's Green Book. Ofgem conducted sensitivity analysis to evaluate the effect of different numbers of comparators and the timing of benefits. It produced a range of results under different assumptions, including a potential loss to consumers of £63 million, but it did not consider the likelihood of each result. So it was unable to estimate whether the loss of £63 million was highly unlikely or not.[18]

16. The price paid by the purchasers represented a 14% premium on the estimated regulatory asset value at the time of the sale. Purchasers can be expected to pay a premium

14 C&AG's Report, para 2.3

15 Qq 3, 77

16 Q 3; C&AG's Report, para 2.11

17 C&AG's Report, para 2.13

18 Qq 30–47

in acquisitions which, in this case, was in line with other disposals in the regulated utility sectors in the UK. Ofgem did not believe that the price paid for the assets or the sale premiums raised any regulatory implications. Its decision to approve the sales was based solely on its assessment of the impact of the sales on consumers, not on the purchasers of National Grid as seller.[19]

19 Qq 78–80

2 Setting the price for the gas networks

17. Ofgem sets price controls for the gas distribution sector. Ofgem sets a price cap for a period of five years, based on targets for efficiency savings that gas distributors should achieve. This limits the price that companies may charge their customers. Setting challenging, but realistic, price controls lies at the heart of Ofgem's duties and is their primary opportunity for delivering customer benefits.[20]

18. Companies that exceed their efficiency targets are able to retain the savings, and thus earn higher profits, until the next price control. Companies are thus incentivised to outperform each other, thereby creating the advantages of competition.[21] At the next price control, the regulator can use this performance information to re-adjust efficiency targets, and pass the benefits through to consumers in lower prices.

How the sales offer the potential for consumer benefits

19. Ofgem believes that consumers will benefit from its ability to compare the costs and operational performance of four independent network owners. Before June 2005 Ofgem could make only internal comparisons of National Grid's costs and business plans.[22] The ability to make comparisons enables the regulator to generate better information to set more challenging targets at the price control. And the introduction of new management teams also increases the potential for efficiency savings through greater industry innovation and the transfer of best practice.[23]

Ofgem's assessment of potential consumer benefits

20. Ofgem calculated that the existence of four independently-owned operators offered the potential to achieve a 1.13% per annum reduction in the operating expenditure between 2008 and 2023.[24] This represented cumulative benefits for consumers totalling £325 million over the whole 15 year period.

21. The benefits of comparative regulation have been evident in the electricity sector. Following the break up of the electricity industry, Ofgem was able to compare the performance of the 12 electricity companies to secure 7.7% annual cost reductions between 1992 and 2003.[25] Ofgem expects to see the benefits materialise in the gas distribution sector but was cautious in its extrapolation of potential savings as there are fewer gas network owners.[26]

20 Q 1

21 Qq 8, 58

22 Q 5; C&AG's Report, para 3.6

23 Ev 18-19

24 C&AG's Report, para 3.8

25 Qq 4, 19

26 Qq 54–55

22. Before the sales, Ofgem regulated National Grid as the monopoly owner and operator of the gas networks, but with no independent source of information to benchmark efficiency. Ofgem sought to address these difficulties at the 2002 price control when it required National Grid to provide performance information on its regional networks.[27]

23. Even without the sales, Ofgem could have set stretching efficiency targets. It concluded that the existence of regional comparators would have enabled a 3% annual reduction in operating expenditure between 2008 and 2023.[28] Over 15 years, this represents a cumulative potential efficiency saving of £830 million.

Figure 2: Ofgem's estimate of additional benefits from the sales and NAO analysis of additional benefits available

	Potential value	**Source**	**When deliverable?**	**Information**
Ofgem's estimate of additional benefits from the sales	1.13% improvement per year, totalling £325 million	Separate ownership of the gas distribution networks following the sales	80% of benefits from 2013	Ofgem is collecting new information from the network owners to analyse performance
NAO analysis of additional benefits available	3% improvement per year, totalling £830 million	Potential efficiency savings regardless of sales	Deliverable from next price control review in 2008	Information should already be available

Source: NAO

When consumer benefits are expected

24. Ofgem does not expect gas companies to achieve cost savings evenly between 2008 and 2023. 80% of savings are expected to come after 2013, with the highest level of savings in the second price control period between 2013 and 2018.[29] Ofgem considers 2013 to be the crucial price review as it will then have five years of information from the companies, thus enabling more detailed comparisons and analysis of time-series data. The timing of potential savings has a significant impact on the consumer benefits calculation; the sooner gains occur, the higher the present value of consumer benefits.[30]

25. Ofgem's last gas distribution price review took place in 2002 and was due to run until 2007. In response to the sales, it decided to extend this until 2008 and then start rolling five year reviews. A one year deferral will enable Ofgem to take into account the first full year of

27 Qq 57, 90

28 C&AG's Report, para 3.17; Qq 60–63

29 Q 7

30 C&AG's Report, paras 3.14–3.15

data from the new network owners. It also allows Ofgem to prioritise its workload by staggering price control reviews in different parts of the energy market.[31]

26. Deferring the price control has a potential benefit for National Grid and the new owners if they outperform the efficiency targets set at the last price control, and thus achieve higher profits for a year. As a result, consumer benefits may be delayed, or lost. But, conversely, deferring the price control has risks for the owners. In particular, there is continued uncertainty over Ofgem's treatment of issues such as capital overspend and the leakage of gas.[32] Ofgem did not, however, evaluate the costs and benefits of deferring the price control review for the network owners, nor did it quantify the impact for the consumer.

27. Ofgem will put in place an interim price control for the year 2007–08. This will not be a full scale review but will involve a thorough cost analysis. If companies have driven costs down further than originally expected, Ofgem will take this into account and set lower prices for 2007–08. The full review will consider whether targets have been too generous and, as necessary, adjustments to targets will be made at the full review in 2008.[33]

The uncertainty of consumer benefits

28. The benefits of the sales come from reduced costs for gas distribution. These reductions should be reflected in lower prices to companies that retail gas. The retailers in turn may pass on the reductions to households and companies, as end consumers. Making sure that benefits are realised through this complex chain depends on several factors:[34]

- *the practicality of achieving the cost reductions*. At present, Ofgem's estimates are based on high-level assumptions, as opposed to a detailed understanding of the operational areas where potential efficiencies may lie; and
- *competitive conditions in the energy market*. In a competitive market, any reduction in the cost of gas distribution should be passed quickly from gas retailers to gas consumers. In future, however, a highly concentrated retail gas market, with economic barriers to entry, may mean that lower gas distribution costs are simply reflected in higher margins for incumbent gas retailers, and not passed on to consumers.

Ofgem's role in delivering consumer benefits

29. Ofgem cannot, itself, deliver the consumer benefits but must create a robust regulatory framework that provides incentives to encourage innovative and efficient behaviour. Ofgem has begun to collect data on the performance of the network owners. The

31 Q65; Ev 18-19

32 Qq 69–71

33 Q 21; Ev 18-19

34 C&AG's Report, para 4.2

availability of existing data should also help Ofgem to set challenging targets at the next price review in 2008 and deliver customer benefits as early as possible.[35]

35 C&AG's Report, para 11

3 The physical structure of the gas networks

30. The Health and Safety Executive (HSE) has primary enforcement responsibility for gas safety. Ofgem's role, as the economic regulator, is to ensure that the network owners can finance the maintenance and extension of the networks.[36] It has a statutory responsibility to consult the HSE about gas safety issues. The two bodies have established a Memorandum of Understanding which sets out the arrangements for co-operation and the exchange of information.[37]

Safety

31. Each network owner is required to prepare a safety case, showing how it is safely managing the conveyance of gas. The safety case has to be accepted by HSE before gas can be transported. In response to the announcement of the sale, HSE reappraised its safety case processes to ensure that they addressed the risks of a fragmented industry structure. This reappraisal led HSE to strengthen the importance of human factors, such as relevant experience, and introduce an enhanced programme of audits to ensure that new owners comply with their obligations.[38]

32. Ofgem collects data from the network owners on the number and duration of non-contractual interruptions. As of June 2006, there had been six unplanned interruptions to the supply of gas since the sales.[39]

33. There are some 23,000 reported leaks a year from iron pipes that were installed prior to 1997.[40] Cast iron pipes were used to transport gas until the 1970s when they were replaced by ductile iron pipes. These were found to fail unpredictably due to corrosion and were subsequently replaced by polyethylene, a robust but flexible type of plastic.

34. HSE has approved an accelerated programme for the annual replacement of iron pipes, which requires all pipes designated 'at risk' to be replaced within 30 years. 'At risk' pipes are those within 30 metres of buildings. The mains replacement programme amounts to 102,000 kilometres of pipes and covers 39% of the network **(Figure 3)**.41

36 C&AG's Report, para 6.2

37 Ev 16-18

38 C&AG's Report, para 6.3

39 Ev 17

40 Q97

41 Q117; Ev 17-18

Figure 3: Length of mains to be replaced under HSE's programme

	NGG				NGN	SGN		WWU	
2005/06	**EoE**	**Lon**	**NW**	**WM**	**NoE**	**Scot**	**SoE**	**W&W**	TOTAL
HSE Enforcement Policy Mains (km)	16,919	10,742	13,152	10,267	16,390	6,802	18,188	9,409	**101,869** (38%)
Total Mains Population (km)	46,504	21,916	33,496	21,575	35,500	23,972	47,546	31,990	262,499

Source: NAO

35. The accelerated mains replacement programme was introduced at the 2002 price review and costs £430 million per annum. The purchasers were aware of these commitments at the time of the sales and will be responsible for meeting their assigned obligations. They will be required to set out their procedures for implementing the replacement programme, including the prioritisation of high risk works.[42]

Funding

36. While the HSE enforces safety measures, Ofgem must ensure that the price control does not prejudice the ability of companies to comply with the HSE's requirements.[43] Ofgem therefore reviews the owners' funding and maintenance programmes when setting the price control. For example, the price control will be adjusted to enable network operators to fund the accelerated mains replacement programme.[44]

37. Ofgem fulfils its obligations by developing a close working relationship with HSE, and draws on their data. It also holds discussions with companies on the quality of assets and hires engineering consultants to carry out inspections.[45] The performance framework seeks to incentivise better customer service, which includes safety. A key measure is the number of gas leaks and Ofgem expects to see a downward trend over the next five years.[46]

38. The new owners funded their purchase largely through borrowing. As a result, they are heavily indebted. Ofgem's view was that the level of debt was not a relevant regulatory issue. However, it is possible that debt-laden companies may be less able to meet new investment requirements, such as extending gas networks to rural areas they do not currently serve, and replacing 'at-risk' iron gas pipes with more robust plastic pipes. Ofgem has undertaken a research programme to consider these financial issues. [47]

42 Q122; Ev 17-18

43 Q103

44 Qq 106–108

45 Qq 112, 134

46 Q102; Ev 17-18

47 C&AG's Report, para 5.13

Extensions to the gas networks

39. Using gas to provide heating has traditionally resulted in lower energy bills for domestic consumers. It is therefore important that the regulatory regime does not prevent network owners from extending the networks wherever appropriate. Prior to the sale, National Grid had an agreed a programme for extending the network. The sales are expected to have a neutral impact on the number of extensions.[48] Ofgem intends to re-consider this issue at the next price control and will issue a consultation on the subject.[49]

48 C&AG's Report, para 6.11

49 Q113

Formal minutes

MONDAY 27 NOVEMBER 2006

Members present:

Mr Edward Leigh, in the Chair

Mr Richard Bacon
Mr David Curry
Mr Ian Davidson
Mr Austin Mitchell
Dr John Pugh
Mr Don Touhig

Oral evidence

Sir John Bourn KCB, Comptroller and Auditor General, was in attendance and gave oral evidence.

Mr Marius Gallaher, Alternate Treasury Officer of Accounts, was in attendance.

The Comptroller and Auditor General's Report on Delivering successful IT-enabled business change (HC 33-I&II) was considered.

Mr Ian Watmore, Permanent Secretary and Head of Group, Delivery and Transformation Group, Cabinet Office, and Mr John Oughton, Chief Executive, Office of Government Commerce, gave oral evidence (HC 113-i).

Draft Reports

A draft Report (Improving literacy and numeracy in schools (Northern Ireland)), proposed by the Chairman, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 19 read and agreed to.

Conclusions and recommendations read and agreed to.

Summary read and agreed to.

Resolved, That the Report be the Second Report of the Committee to the House.

Ordered, That the Chairman make the Report to the House.

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

Another draft Report (Collections management in the national museums and galleries of Northern Ireland), proposed by the Chairman, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 17 read and agreed to.

Conclusions and recommendations read and agreed to.

Summary read and agreed to.

Resolved, That the Report be the Third Report of the Committee to the House.

Ordered, That the Chairman make the Report to the House.

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

Another draft Report (Gas distribution networks: Ofgem's role in their sale, restructuring and future regulation), proposed by the Chairman, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 39 read and agreed to.

Conclusions and recommendations read and agreed to.

Summary read and agreed to.

Resolved, That the Report be the Fourth Report of the Committee to the House.

Ordered, That the Chairman make the Report to the House.

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

Another draft Report (Postcomm and the quality of mail services), proposed by the Chairman, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 30 read and agreed to.

Conclusions and recommendations read and agreed to.

Summary read and agreed to.

Resolved, That the Report be the Fifth Report of the Committee to the House.

Ordered, That the Chairman make the Report to the House.

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

Another draft Report (Gaining and retaining a job: the Department for Work and Pensions' support for disabled people), proposed by the Chairman, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 28 read and agreed to.

Conclusions and recommendations read and agreed to.

Summary read and agreed to.

Resolved, That the Report be the Sixth Report of the Committee to the House.

Ordered, That the Chairman make the Report to the House.

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

Spring programme
The Committee considered this matter.

[Adjourned until Wednesday 29 November at 3.30 pm.

List of Witnesses

Mr Alistair Buchanan and **Mr David Gray**, The Office of Gas and Electricity Markets (Ofgem)

List of written evidence

List of Reports from the Committee of Public Accounts Session 2006–07

First Report	Tsunami: Revision of support for humanitarian assistance	HC 25
Second Report	Improving literacy and numeracy in schools (Northern Ireland)	HC 108
Third Report	Collections management in the National museums and galleries of Northern Ireland	HC 109
Forth Report	Gas distribution networks: Ofgem's role in their sale, restructuring and future regulation	HC 110
Fifth report	Postcomm and the quality of mail services	HC 111

The reference number of the Treasury Minute to each Report is printed in brackets after the HC printing number

Oral evidence

Taken before the Committee of Public Accounts

on Monday 8 May 2006

Members present:

Mr Edward Leigh, in the Chair

Mr Richard Bacon	Helen Goodman
Annette Brooke	Mr Austin Mitchell
Greg Clark	Kitty Ussher
Mr Ian Davidson	Mr Alan Williams

Sir John Bourn KCB, Comptroller and Auditor General, National Audit Office, gave evidence.

Ms Paula Diggle, Treasury Officer of Accounts, HM Treasury, gave evidence.

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL

THE OFFICE OF GAS AND ELECTRICITY MARKETS

SALES OF GAS NETWORKS BY NATIONAL GRID (HC 804)

Witnesses: **Mr Alistair Buchanan,** Chief Executive and **Mr David Gray,** Managing Director, Networks, Ofgem, gave evidence.

Q1 Chairman: Good afternoon and welcome to the Committee of Public Accounts where today we are looking at the Comptroller and Auditor General's Report *Sale of gas networks by National Grid.* We welcome Mr Alistair Buchanan, who is the Chief Executive of Ofgem, and Mr David Gray, who is the Managing Director of Networks you are both very welcome. If you look at the summary of this Report, particularly paragraph 12, page six, I was intrigued by what it says here "Ofgem clarified its role during the sales. In March 2004, Ofgem decided that it would recommend the approval of 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". Why did you embark on this project apparently without knowing whether you needed to maximise benefits for consumers?
Mr Buchanan: I should like to address two issues here. The first is our responsibility under Section 3 of the Utilities Act which is to seek to protect and promote the interests of consumers. That is something that we always do and in the regulated business our opportunity primarily to do that is at the five-year price review situations, whereas clearly in markets we have a monitoring of markets role. With that comment about the importance of the consumer to us, may I move on to this deal? This deal was fairly unique and it is covered extremely well on page 37 in paragraphs two and three. It is outlined in those paragraphs that this is a commercial transaction, a transaction that had a unique transfer of assets under licence condition 29 and it was because of that uniqueness that we took legal advice from a leading QC and that advice was to use a no-net-detriment test. It was on the basis of that that we proceeded on this deal.

Q2 Chairman: So did this legal advice force you or encourage you to take a narrow view of your responsibilities on other projects as well? How important was this legal advice, which is mentioned in this paragraph and which you have just mentioned as well?
Mr Buchanan: It is a very good question and we wanted to know that as well. The legal advice is narrow to this deal because it was such a unique situation. As I said, it related to the transfer of assets under a licence condition and that is therefore how we shall treat it going forward.

Q3 Chairman: If I ask you how you prove yourselves, if you look at paragraph 14 it says there " . . . in November 2003, Ofgem delayed the sales timetable to ensure sufficient time for full analysis and consultation on the impact of 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". Why did you do this? Why did you add delays, complexity and cost to the industry?
Mr Buchanan: One of the lessons learned that we shall take away from this excellent Report from the NAO is that possibly within the process, and it is in paragraph 2.17, we may have made the process more complex than it should have been. That is a lesson learned and a useful part of the process. However, the delay was important in November 2003 because we had received such strong representations from

various parties to the sale to take more time, to analyse the cost-benefit analysis, that we actually effectively put a block on the sale we put in a three/four-month review and the board then looked at that analysis in April. I think that was the right thing to do and indeed whilst I am very keen to pick up some of the criticisms of us in this Report—as mentioned, paragraph 2.17 about perhaps over-engineering it—on the other hand in paragraph 2.11 the NAO very kindly say that we consulted very well. I should not want there in any way to be a suggestion that we did not sound out all the parties through this process. We sought to do that. In fact, David told me last week, when we went back to have a look, we actually did 13 consultations in this process, which is a lot.

Q4 Chairman: The Report tells us that Ofgem concluded that the potential benefits to customers from the sales were most likely to be £325 million. Does that indicate to the Committee therefore that there was a huge level of inefficiency in this industry?
Mr Buchanan: The benefit that the electricity industry had had since 1990 was that it was broken up. Basically in England and Wales you had 12 companies and through the price reviews of 1995 and 1999 the regulator effectively took 50% of the income away from the companies they put in cuts of what are called "P-noughts"—one-off price cuts of 50% combined over 1995 and 1999. You did not have that in the gas industry and in fact the gas industry was treated as a job lot. The regional companies and the national transmission company, Transco, were effectively given one price control in 2002. A year later that was broken down into the constituent eight regional companies. Effectively, in gas you got the eight regional companies in 2003, whereas in electricity you had the 12 England and Wales regional companies in 1990. Therefore from 1990 onwards in electricity you had the benefits of comparative regulation. You can clearly see that in figure 12 on page 22 because the electricity industry delivered 7.7% annual cost saving 1992 to 2003 was the timescale used in that analysis.

Q5 Chairman: So the reason you did not identify this £325 million before was because, in your words, it was viewed as a job lot. Is that right?
Mr Buchanan: We believe comparative analysis is a substantial benefit to getting more for the consumer and we estimated in this Report that 95% of the benefits will come from comparative analysis.

Q6 Chairman: It tells us in the Report "The predicted benefits are subject to uncertainty". I am sure that is right and it may be an understatement. "The benefits are forecast over a long time frame, whereas the costs of restructuring are already being incurred by the industry. 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". So the obvious question to you is: before we get any of this benefit to the public, are we just paying for restructuring?
Mr Buchanan: The good news is that we have a track record and comparative analysis works over a track record. If I hark back to the answer to your previous question, we have basically seen that track record work from 1993 to 2005 for the electricity companies and what we are saying for the gas companies is that the gun is effectively going to go in 2008 and going to run forward.

Q7 Chairman: So in that sense this Report is wrong and the customer will not have to wait 15 years for any benefit.
Mr Buchanan: What the Report has clearly identified is that that 2013 price review is the real crunch price review, because it is at that point that we have captured five years of data, five years of benchmarking and yardstick and comparison between the companies and that is why we estimate that 80% of the benefit comes after 2013, which is exactly what happened in 1995, five years after the electricity companies had been running under comparative analysis. I am going to hand over to David for the detail.
Mr Gray: There is an important point which is that the costs concerned are those that were being imposed on the other participants in the industry. We took a very firm view early on that, to the extent that there were costs of restructuring that would be felt by National Grid and by the buyers, they should pay those costs and those costs should not in any way be passed through to customers. That was very clear. Our assessment of the costs was based on the question of what sort of systems users of the transportation system would have to invest in, in order to work with the new set-up. It was about £25 million in up front costs and then about £7 million per annum and that gives you, in present value terms, the £100 million we talked about. We took the view that that impact, the £25 million up front, was small enough that it should not put us off allowing the sale, given the substantial nature of the benefits that we saw coming later.

Q8 Chairman: How can you be sure that these gas companies will pass on the benefits of cost savings to the consumer?
Mr Buchanan: This is how the five-year price regulatory cycle works. Effectively, the companies compete aggressively amongst each other, we collate that information, we see what we can capture for the consumer and it is at the price review that we shall capture that benefit for the consumer. We are committed to doing that. Sir John Bourn clearly said in his comment about us that it is well done so far, but we have to get everything now, and we fully understand that.

Q9 Chairman: What if I said to you in summary that, after reading this Report, it is clear that there are so many uncertainties in all this that it is by no means

certain that you will be able to pass on any benefits to the hard-pressed gas consumer, in other words us, as opposed to the people running these companies?
Mr Buchanan: One of the certainties of the energy regulatory regime has been that a track record has now been delivered since 1990 of stable, consistent, tough regulation and I would hope that that would give confidence to those looking at this.

Q10 Chairman: You would hope?
Mr Buchanan: I would hope.

Q11 Chairman: How much has all this restructuring cost?
Mr Buchanan: I cannot give you an absolute certainty, but what I can say is that the track record we have and the commitment we have to do the best for the consumer and why everybody comes to work at Ofgem is for our fundamental section three responsibility that we shall seek to get the best for consumers.

Q12 Chairman: Why can you not say "we guarantee"? Why do you use the words "we hope"?
Mr Buchanan: Largely because, looking forward over a period of 15 years, there may be situations that we could not foresee at the moment. Laws may be passed, changes may occur in the way businesses operate and we would have to take that into consideration.

Q13 Chairman: How much has this restructuring cost?
Mr Buchanan: In terms of . . .?

Q14 Chairman: How much has it cost to the companies for instance?
Mr Gray: I do not have an estimate of what the cost was for the companies concerned because we made it entirely clear that they had to pay that, so it comes from their own shareholders' pockets essentially. The costs for other companies in the industry were that £100 million I referred to, and our own costs were the £2.5 million figure that the NAO reported in the Report.

Q15 Helen Goodman: I wonder whether I could ask you to turn to page 22 and figure 13. This is the one that shows the scope for cost reductions in the gas distribution sector. I was rather concerned to read that you were assuming a £325 million cost saving. Is my understanding correct that you have captured that already in the existing regulatory structure?
Mr Buchanan: No, that is not right. This is what we believe can be captured.

Q16 Helen Goodman: Right. But the NAO are saying that in fact another £830 million could be captured.
Mr Buchanan: Correct.

Q17 Helen Goodman: Do you dispute the NAO figure, or do you accept it?
Mr Buchanan: When we look at the NAO figure, the best words for us to use are that it "appears to be a reasonable assumption for the NAO to make". In the light of figure 12 just above it perhaps you can see where the NAO was drawing its information from, but the figure that we focused on in our consultants' review and in our review was the £325 million. I am not disputing the NAO's figure it looks reasonable but we are not committing to that figure.

Q18 Helen Goodman: It is just that normally the numbers in the NAO Report have been agreed with the department or whoever it is, so I would have expected you to have agreed it.
Mr Buchanan: It may be my use of the word "reasonable". I am sorry if I am causing trouble there.

Q19 Helen Goodman: My concern is of course that if, when you come to the next price review, you work on the assumption that the savings achievable are £325 million and you ignore this £830 million, gas consumers are going to be paying over the odds. Do you think there is that risk?
Mr Buchanan: I would hope very much that the evidence from what we have seen in the electricity sector, as evidenced in figure 12, will be the kind of performance that we shall see unleashed in the gas sector. I fundamentally believe that comparative analysis will ensure that the companies look for their cost saving of 77%, which is the amount that they can go for of their cost base and which is controllable by them. I would hope to see cost savings coming from how they address their working practices, how they address their IT, the transport fleet et cetera. I would be hoping and confident that we could see that.

Q20 Helen Goodman: When is the next pricing review?
Mr Buchanan: We decided to extend the price review and we are currently into 2008 then we shall start the five-year rolling programme out to 2023.

Q21 Helen Goodman: So that fact obviously brings two questions. First of all, at the point at which the restructuring was taken the efficiency savings should have kicked in, so why did you extend the pricing review and why did you not re-jig it to incorporate this higher figure?
Mr Buchanan: Perhaps I might deal with why we opted for the one-year rollover. Essentially three reasons: one, we wanted more time to collate information so that we can do as good a review as we possibly can in 2008. Two, we wanted the new management teams, the innovation and the drive that they will bring into the process, to have a bit more time before that price review to get hold of the companies and then work them through. Those are the two key issues. The lesser issue is work prioritisation. David and his team are running three major price reviews this year and therefore in terms of handling that workload it is the weakest of the

three arguments. We felt that as a package, going for the new five-year review starting in 2008 made a lot of sense.

Mr Gray: The most important task for that review is to set up a framework which will allow us to measure what advantages new management can bring to the industry, so that we can make sure we capture the benefits arising from that in future price control reviews. We wanted to do it as soon as we could in order to set that clock starting, but we needed the benefit of at least one or two years of base data after the sale in order to set a starting point that we could measure from for the next review.

Q22 Helen Goodman: I can understand that. Is there any way in which you will be able in 2008 to capture the efficiency savings that we have in this intermediate period for the subsequent period or are they lost to the customer for ever?

Mr Gray: To the extent that we can identify any efficiency savings before 2008, we shall certainly try to capture them in that review. As I said, the evidence will come through mainly in the longer term when we get a five-year period of seeing what these companies can do and then in the first review after that, I would expect us to be able to make major advances in passing through those savings to customers. That is essentially how it has worked in the other sectors. You see what the industry can do, you give them the biggest incentives you can to make them compete with each other to demonstrate best practice and then you impose that best practice on the other companies. That is what we shall do in gas.

Q23 Helen Goodman: I just want to ask you a question about the operation of Ofgem as well and the fact that you were under-staffed and you had to employ consultants and you ended up spending five or ten times as much as you anticipated spending. Obviously this is rather unsatisfactory. Could I ask you whether you think you are properly staffed now?

Mr Buchanan: I welcome recommendation 19j in the Report, which highlights that we always need to keep our eye on our contractors and the amount we spend on contracting. You have picked out a sentence within the Report which is a thoroughly reasonable thing to do. Equally reasonable to do, to give that balance, would be to pick out paragraphs 2.5, 2.13, 2.11 where what the team did in terms of good working practices and good planning and good consultation is all commended and it is all down to David and Sonia Brown, his lead director on the deal. In terms of being satisfactory, what I should like to give you some confidence over at Ofgem is that we take financial management extremely seriously and in the last three years we have driven our overall consultants' budget down from £8 million to £6 million, which will be released in a couple of weeks' time. We also operate under an RPI minus X price regime ourselves. It is tougher than Gershon and Lyons have set for the rest of Whitehall and we have beaten that handsomely this year and will return £2.8 million to the licence payer this year without, I believe, in any way putting the work that we do at risk and that includes those consultants' costs. Unfortunately, in terms of the way that the budget worked in October 2003, we have basically put a large lump of money in the contingency rather than put it firmly directed to DN sales. Therefore, although the trend of consultancy is clearly falling at Ofgem by £2 million over the last three years, you are right to point out that we had not clearly identified where the consultants' budget was going. I welcome the comment, because I can use it internally to say "Look at consultants. The NAO and the PAC are watching us".

Q24 Helen Goodman: We have a general concern because departments come to us continuously with large consultancy budgets and one is bound to ask oneself the question and I am going to ask you. Are we, in general, not staffing up the Civil Service enough and not having the level of skills internally that we ought to have and consequently paying more for people from the private sector? You tell me you saved £2 million, but I could say to you that perhaps if you staffed up Ofgem a bit more, with three more economists or something, you might save £4 million.

Mr Buchanan: Yes. It is a very good question and is a topic of much discussion. At the moment we believe we can do our job and we believe we can do it well for the consumer and it is a point which you validly make, which is that if you want to hire unique expertise . . . This was a unique deal, effectively a corporate finance deal. David was one of the lead investment bankers in the city for 20 years and it was a deal made in a way for David to run. If we had not been fortunate enough to have David at Ofgem, one could well argue that we would have had to go out and pay a very large sum of money to hire somebody to help us to get that kind of information so that we could run this deal and be part of this deal. The point you make is a very interesting point. For us in this specific case—and I know many of you have run businesses and many of you have been in the financial sector as well—gearing up with expensive employees, only to find that once the deal was done, we probably would not have another deal like this for many, many years, would make it very difficult to justify hiring people. The question which we could maybe take further outside this forum is: am I worried about attracting staff into Ofgem? I have to tell you that two of our major competitor organisations, Ofcom and the FSA, pay substantially higher at the senior management level than we do because we are very much within the Whitehall pay structure and they are not.

Q25 Chairman: Why is that?

Mr Buchanan: That I believe is more historic than anything else. I believe Ofcom and the FSA have negotiated their financial, legal structure differently from us. Certainly if we are out trying to find senior manager levels and we are competing with those kinds of organisations, then it is difficult for us, there is no question about that. We welcome your interest in it.

Mr Gray: Your initial question was quite specific and it was "Are we properly staffed now?". The answer is that we are properly staffed, although it is always a struggle at the margin and we are always losing people and having to recruit more. We are properly staffed for our normal business. The point about this project though was that it was a big one-off which came along and was going to require a peak of activity over a period of about a year. It is not sensible for us to have a team waiting around in case a project like that comes along. That is the area where we should use consultants. In general, I am thoroughly signed up to the idea that we should recruit our own talent and have it in-house for the day-to-day business, but for the one-off projects we should go outside and we did in this case.

Q26 Greg Clark: "Hope" seems to be the key word from the evidence so far. If one were to do a word search, it would appear more than any other word.
Mr Buchanan: Yes.

Q27 Greg Clark: It is good that you are positive. According to your website, your first priority is to protect customers. Correct?
Mr Buchanan: Indeed.

Q28 Greg Clark: Just looking at some of the figures, on page 22 paragraph 3.10 the central value of the costs for consumers is £100 million, is it not?
Mr Buchanan: Yes.

Q29 Greg Clark: But according to footnote 27 it could be as high as £118 million. Correct? Just turning a couple of pages on to page 24 figure 16, if the benefits occur in the second and third price controls, then the actual present value of those benefits is only £55 million. That is correct, is it not?
Mr Buchanan: Yes, that is what it is saying in figure 16.

Q30 Greg Clark: So it is possible, on these forecasts in the Report, that the net effect on the consumer could be benefits of £55 million, costs of £118 million, in other words a loss of £63 million. That is correct, is it not?
Mr Gray: That would assume that we made no progress in this first review in identifying additional savings.

Q31 Greg Clark: No, no, I am purely looking at different scenarios which are presented here in terms of when the savings could come out and what the costs might be. There are scenarios which are clear enough to be in the Report in which there could be a pretty substantial loss, £63 million, to the consumer. That is a correct statement of fact, is it not?
Mr Gray: That was not a scenario that we analysed in our cost-benefit assessment.

Q32 Greg Clark: Why not?
Mr Gray: We looked at a whole range of scenarios as to when we should be able to get the benefits and how big they would be at the various stages over the next three price controls. We came to the view that there was a probability distribution curve in which we were really very confident that the actual value of benefits would be higher than the central estimate of costs of £100 million and very confident also that they would be higher than the top-end range of £118 million.

Q33 Greg Clark: Let us come on to that. The NAO thought fit to point out, helpfully, that if the benefits do occur not in the first phase but in the second and third price controls, the value of the benefits would only be £55 million. I am interested in this probability distribution. You did assign different probabilities to each of these potential outcomes.
Mr Gray: We looked at a range of possibilities and we looked at what we thought was—

Q34 Greg Clark: Did you assign probabilities to each of these outcomes? I mentioned one outcome which would be a substantial loss to the consumer. What was the probability of that?
Mr Gray: We did not think it was a likely outcome that there would be no benefits to consumers in the first review.

Q35 Greg Clark: I am sure your judgment is very wise, but it would be interesting to know what percentage of probability you attached to that.
Mr Gray: We did not go to putting specific percentage probabilities on different distributions.

Q36 Greg Clark: So despite the fact that your remit is to protect the consumer, in the Report there was clearly a possibility that the consumer could actually lose and you did not assess the likelihood of that.
Mr Gray: We assessed the likelihood of all sorts of scenarios in which the consumer might lose.

Q37 Greg Clark: I am interested to know what assessment you made of how likely that was.
Mr Gray: It was not likely that there would be no benefits.

Q38 Greg Clark: But you did not assess it as a probability.
Mr Gray: We did not go through an exercise of putting specific probabilities on different outcomes for the timing of savings—

Q39 Greg Clark: Is that not a bit reckless, when your prime responsibility is a bit like the medical Hippocratic oath, which refers to "do no harm"? That applies to you does it not, for consumers? You must first do no harm to consumers, yet there is a possibility here that you are going to do harm to consumers and you did not assess the probability.
Mr Buchanan: What was very useful for us was that a range of Reports was done and, as you can imagine, they were very much made available to us. I can remember two in particular where external consultants were used by shippers and those who were not keen to see this deal go through who presented very clearly to the authority their view that there would be.

Q40 Greg Clark: But you did not take a view. So you relied on shippers presenting their views.

Mr Buchanan: No, we looked at their consultants' Reports. Quite clearly they hired leading consultants and we took that into consideration at the authority when coming to our conclusion as to whether there was no net detriment to consumers on this deal.

Q41 Greg Clark: Can you turn to page 23 of the Report and look at paragraph 3.16? It says "To take account of the risk posed by uncertain outcomes, the Treasury Green Book recommends calculating the 'expected value' of risks. This is a technique which can reflect all known risks by multiplying the likelihood of a risk occurring by the size of the outcome in monetary terms". Ofgem could have used this technique. Why did you not follow the Treasury Green Book?
Mr Buchanan: By and large we did. If you look at paragraph 3.5, it says that—

Q42 Greg Clark: On my specific point. Why on this point did you not follow the Green Book?
Mr Buchanan: If I could take you to the Green Book, reference 3.5, in many respects Ofgem's cost-benefit analysis followed the Treasury's Green Book.

Q43 Greg Clark: In many respects, but in this respect it did not.
Mr Buchanan: One of the learning points that we have taken from this—and you always learn things from these reviews, that is what they are here for, to help us—is that we can take that away and be alive to the fact that we did not use this particular sensitivity analysis. If I refer you on to page—

Q44 Greg Clark: Do I infer from that that you should have used the Green Book? Is that what you are accepting?
Mr Buchanan: We felt that we used a wide range of sensitivity analyses which the NAO have reviewed on page 38—

Q45 Greg Clark: Sorry, you just said that there was some learning to be taken from this. I just want to clarify this. Are you saying that the NAO brought to your attention that there was some advice in the Green Book that you should attach probability to different scenarios and weigh them up? You did not do that. Should you have done it?
Mr Buchanan: We did use a degree of probability analysis in the other sensitivity work which we did, which was thoroughly audited and is outlined on page 38. Are we as an institution big enough to take a recommendation? Yes, we are. Paragraph 3.16 is clearly a recommendation to us for something that we should have a look at and we have taken that on board.

Q46 Greg Clark: Are you not required to follow the Green Book?
Mr Buchanan: By and large. As I said, paragraph 3.5 suggested that we were following the Green Book.

Q47 Greg Clark: It is odd that the Treasury Green Book can be followed "by and large". Either you follow it or you do not.
Ms Diggle: The Green Book is meant to be guidance on best practice. In any particular scenario it is for the people using it to make a judgment on how best to use it. There are lots of choices in it and if the accounting officer feels that some way of handling it is actually best in those circumstances, it is for him or her to make that judgment.

Q48 Greg Clark: Very helpful. So it was a considered judgment that you thought it best not to attach probabilities to these scenarios.
Mr Buchanan: Indeed.
Mr Gray: We need to distinguish between two types of risk. We did look at this question of risks and what could go wrong. The risk of when the savings are delivered is one that is to some extent in our control because it is delivered through price control reviews, which is what we do. There were other risks which went outside our control and, for instance, one of those was the number of companies that would be sold and therefore the number of comparators we had. In that case we looked very specifically at what the impact would be of having four comparators or fewer.

Q49 Greg Clark: We are digressing from the subject. There is clearly a scenario in which the consumer is going to lose money.
Mr Gray: No, I am saying that in the areas where we could identify a specific risk, such as "What if they sell only three companies rather than four" or "only one company rather than four", we looked at those specific risks quite accurately.

Q50 Greg Clark: We are talking at cross-purposes. The NAO have identified the risk that the consumer is going to lose money and you made no assessment of what probability that is. Can we move on to a different subject? You did consider the possibility of a constant rate of improvement between 2008 and 2023, but, following discussions with the industry, you decided that savings would not be linear and they would come later on. In other words, the industry persuaded you that the savings would come between 2008 and 2013, but the costs of course are immediate, are they not, or forward looking? Is it not the case that the industry has suckered you into a soft settlement with that first period and the much more valuable period is later and of course time value of money means that that is much less valuable to the industry?
Mr Buchanan: If the industry thinks there is a settlement and thinks it has suckered us, then more fool it. I have the distinction or otherwise of having followed this industry since 1988 and therefore when I look at what happened in the electricity industry through the 1990s, by obtaining the data and by providing that five-year period of active competition amongst the companies, 1990 to 1995, the regulator was able to insert a one-off cut of basically 25% in 1995. The companies then were thoroughly competitive. I can give you individual examples.

Q51 Greg Clark: How many companies were there in the electricity industry?

Mr Buchanan: There were 12 in the electricity industry in England and Wales.

Q52 Greg Clark: How many are there going to be in this industry?
Mr Buchanan: There are eight DNs.

Q53 Greg Clark: What happens if they are not operated as separate businesses, as is entirely possible?
Mr Buchanan: What is interesting is that at the last electricity price review we basically had seven/eight management groups owning the electricity companies, but we did the price review of the individual units.

Q54 Greg Clark: The consultants that the NAO brought in looked at this and were concerned at the small number of comparators even through this. So you are basing your assessment on what happened in these other industries but the NAO point out on page 45 that there are only eight DNs compared with 14 DNOs and 22 water companies. This number could be reduced further to only four, so there is a risk there, is there not, that the 95% of the gains that you expect to come from comparative competition have nowhere near the number of comparators that these other industries have? Is that a risk which you have modelled?
Mr Gray: We start from a position in this particular sector where we have no comparators; at least we only have one. Therefore what we have been having in the past is a one-to-one dialogue with somebody where we could not prove our case.

Q55 Greg Clark: Clearly if you are basing your estimates, your projections, on what happened in other industries when you have many fewer comparators than those other industries, that is a risk.
Mr Gray: Yes indeed.

Q56 Greg Clark: I am wondering whether you modelled the likelihood of that compromising your ability to deliver.
Mr Gray: That is one of the reasons why we were quite cautious in extrapolating directly from the other sectors to this one in looking at the test of whether we can be confident that there will not be a detriment to the consumer.

Q57 Kitty Ussher: You said that the reason why you thought these sales were in the interests of consumers was that 95% of the benefit for the consumer mainly came from having comparators, as we have just heard. Yet you also said that you had already effectively been looking at the regional business units for the purpose of your regulatory activities in the last price review in 2004, so in effect you already had comparators. Is that not true?
Mr Buchanan: In the electricity industry, that is right that was the price review in 2004. However, for the gas industry this will be the first time that we are effectively doing a clean review of the regional gas companies. The last gas review was in 2002, which was done as a job lot with the national Transco gas transmission business.
Mr Gray: We have since then, and had anyway, taken steps to separate the price control into individual price controls for the eight regions, so you are right in the sense that we could have looked at a comparative assessment between the eight DNs all still owned by Transco. The important learning point that we have from the last 15 years frankly is that it is different management rather than simply a different licence that gives you the information. You could achieve a certain amount by comparing DNs when they are all owned by National Grid, but frankly they are all going to adopt the same policy they are going to adopt national approaches to how they do certain types of job. The value comes from having new management who will do things differently, will demonstrate to us what can be done so that we can then impose that best practice on the other companies and four comparators is a lot better than one in that sense.

Q58 Kitty Ussher: They may all have the same top management, but it is standard practice within organisations to break it down into business units precisely to have, internally for their own purposes, those types of comparators. So I am sure the fact that it is all the same company means that each regional organisation would have been identically efficient in fact, quite the opposite.
Mr Gray: No, but equally there is no incentive on one of those regions to demonstrate to us best practice. If they are better than the other components of the same group, the pressure is going to be on them not to make that obvious to us, whereas an independently-managed and independently-owned distribution business can get some financial benefit out of demonstrating to us that things can be done better, because we allow them to keep the savings until the next price control review, at which point we then reset everybody's allowance on the basis of that new evidence and pass the benefits through to customers. It is having different management groups which can see some commercial advantage in outperforming each other. What we are trying to do in a regulated sector is get the advantages of competition in a sector which is intrinsically not competitive. You find that you can make them compete really quite effectively with these incentives for cost savings.

Q59 Kitty Ussher: I am sure it would be easier for you if they were separate companies, which is indeed why you have supported the sale, but the point that I am trying to probe is that you may get quite a lot of that advantage by regulating in a different way a larger group broken down into business units. Indeed, if you turn to page seven, paragraph 16 "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 which will deliver larger savings for the consumers". That makes it quite clear that by regulating the business

units, as opposed to the entire company, you believe that you could get substantial benefits for consumers.
Mr Gray: We believe that could improve what we could do by having separate price controls within the same ownership. We think we can improve it a lot further by the evidence that will come from separate ownership, as well as separate price controls in the same ownership.

Q60 Kitty Ussher: Were the savings of £325 million that you quantified additional savings compared with the situation of being able to regulate regionally anyway, which you had just begun to do?
Mr Gray: Yes, on our best estimate.

Q61 Kitty Ussher: I do not quite understand why you cannot get the information that you would require out of National Grid if the regional parts were not sold off. Surely you could require those accounts.
Mr Gray: We could get the information, we can get as much detail as we like off them separately, though there is a question over the regulatory burden you impose by asking for more and more detail. What gives us the incremental benefits and the confidence that we will get incremental benefits, is having different thought processes, different management thought processes applied to the same business, where there has only been one before, so that we can do what a market normally does, which is favour the people with the best approach and the lowest costs and encourage them to carry on pressing for lowest costs.

Q62 Kitty Ussher: If the £325 million is the additional benefit, even after taking account of the fact that you were going to regulate by regional unit anyway, what is the same sum for the calculation you made a couple of years earlier when deciding to regulate by regional unit, ignoring the possibility that there might have been a sale? I am trying to work out to what extent the benefits that are already happening have been accelerated by a sale. Am I making myself clear?
Mr Gray: We did not make a specific calculation at that stage because we simply had no evidence to base it on. We have not regulated separate companies all owned by the same group in that sense previously and therefore to make a quantified assessment of how much we thought we could get out of it is difficult. When I said "our best estimate", that is what it is. You have to take a view on how much you think you can achieve with separate companies, same ownership, and then there is much more evidence as to what you can achieve with separate companies, different ownership, because we have the electricity industry and the water industry to look at and the track record is very positive in that.

Q63 Kitty Ussher: I understand that, but it is still theoretically possible that you could have achieved quite a lot of those savings by not having sales because it is an untested model. You were going down that road, then National Grid came to you and said "sales" and you said "Oh, that must be better" but in fact, it is quite theoretically possible that the approach you had already tried to take would have led to significant savings.
Mr Gray: In theory it is possible and in practice I am sure we would have got some benefit, but if you look at our experience with electricity distribution, with the companies which own more than one distribution company, we actually learn much less from comparing those two companies with each other than we do from comparing them with ones under separate ownership. We can see real track record advantages of separate ownership to the extent that you can track efficiency movements in some of the companies over the last 15 years and see how the pace changed with different ownership with new ideas, which came in when there had been corporate transactions in the sector and so on. We have a high degree of confidence in the incremental benefit of different management teams.

Q64 Kitty Ussher: But compared with the "no change" scenario, the £325 million may actually be less if the previous approach had actually worked quite well.
Mr Gray: If we had been very successful in regulating separate companies in the same ownership, yes, it would be less. We had to take a view on what we thought we could achieve by one method and what the added benefit was of the other.

Q65 Kitty Ussher: I understand. Thank you for explaining. I want to turn to the fact that you have postponed the price review, which seems to me, to be totally honest, a rather odd thing to do. You said a few minutes ago that there were three reasons for this. Can you say exactly when you made that decision to postpone the gas distribution price review by one year?
Mr Gray: We actually made the decision before this deal was announced by National Grid. We were doing it anyway and the reason for that was, following the merger of National Grid and Transco which brought together electricity and gas transmission, that we wanted to be able to look at the transmission as a business separately without the clutter of doing a job-lot on gas transmission and gas distribution. We actually separated out the distribution price control and delayed it by a year in order to allow us to do a proper job on transmission.

Q66 Kitty Ussher: That contradicts what has just been said. You said you wanted proper data from the break-up, from the sale.
Mr Gray: As it happens, we reviewed this decision once we knew about DN sales and in fact the timetable works quite well, because it gives us a review for commencing in 2008, gives us the chance to have effectively two years of data as to how these companies look in separate ownership. We only had ten months of the first year, which was last year. This financial year we shall have 12 months and then we shall be able to use that in setting a price control for the next five.

Q67 Kitty Ussher: National Grid presumably knew that the price review was being postponed while they were considering a sale.
Mr Gray: Yes.

Q68 Kitty Ussher: Can you explain the precise timetable there?
Mr Gray: Yes, they did.

Q69 Kitty Ussher: You announced it at the same time that they were considering a sale. Presumably this increased the value of the sale to National Grid quite substantially, because every single distribution price review in gas and electricity has led to a tightening of profit margin, an incentive towards innovation, so in a sense it is a windfall gain by the company and increases the value of the sale they should have.
Mr Gray: Sorry, I may have misled you. It is not the case that there will be no price control review for that single year: it is just that for the extension year, as we call it, we have to do a rather simpler process because it would be disproportionate to put the same amount of effort into that. For that year we have to set a price control and to the extent that there are benefits we can see that we can capture in that year, we shall do it. It is not a windfall gain, or it only is to the extent that we do not spot things that we should spot.

Q70 Kitty Ussher: That is precisely why. They could do all the efficiency savings that you were expecting them to do in the previous price control and more and not tell you, knowing that you are not going to do a rigorous piece of work, and then take away that excess profit for that year, knowing that you are not going to look at it properly for another year. It is a gain for them, is that not correct?
Mr Buchanan: I shall give the crude answer which is that any company which seeks to gain the system and basically hood-wink the regulator will come seriously unstuck when they come up to the formal price review. The point of getting clear data, the point of being over these businesses like a bad rash, is so that we can see what they have done and if they do that, then we shall take the benefit and cull it for the consumer. That is what firm and fair regulation every five years is about.

Q71 Kitty Ussher: Well that is fine if it is all the same company, but if in the meantime they have sold companies with a higher value than they otherwise would have had because you have postponed your in-detail price review and have pocketed those gains and given them to their shareholders, you cannot then regulate the sold companies more harshly because of what National Grid centrally has done.
Mr Buchanan: We are only at the early stages of this one year of rollover price review, but the really interesting thing I guess is that the companies are really quite anxious about this one-year rollover because of the issue of shrinkage. What is shrinkage? Shrinkage is gas which leaks from the system. As you are aware, the price of gas has sadly gone through the roof in the last two years and therefore the companies will be approaching this one-year rollover in a very nervous state of mind indeed as to how we are going to handle things like that. Funnily enough, rather than from your angle, which is thoroughly reasonable, to say "Gosh, these companies are going to get a one year free ride" in fact, they are going into this price review pretty worried that we are not going to make any change or resolution on this issue of shrinkage.

Q72 Kitty Ussher: If, when you do the proper price review, you find out that in fact that was all a façade and they have huge regulatory teams to make you think that they are worried and that in fact there was a direct transfer from the consumer to the shareholder of National Grid, how can you, once the sale of that has actually taken place, make sure that the consumer is reimbursed? You cannot force National Grid shareholders to pay money back to the customers of a business which has already been sold.
Mr Buchanan: I think your question is driving at whether we have a view on special dividends or buybacks or certain levels of dividend derived from a corporate deal. Is that it?

Q73 Kitty Ussher: No. It seems to me a fairly crucial point. If by postponing the price review gas consumers have had a worse deal, National Grid has sold a company that is worth more because it has not been harshly regulated, thereby benefiting their shareholders—
Mr Buchanan: There is no evidence to suggest that it has been a holiday for them. What is interesting is that after the 2002 price review, the Lattice Company, which was the parent company owner, traded at a discount of its regulated value. The company very nearly went to the Competition Commission in anger at the regulatory regime at the time I was not here at the time, but I knew from where I was that that was very close. There is no sense that there has been a soft deal and there is no sense that there is going to be a soft deal on the rollover. As I said, I think the companies will actually be going to this rollover extremely agitated about what we are going to do.

Q74 Mr Mitchell: Coming from your background and with your ideological pre-suppositions, what was your starting position when this proposal came up? To flog or not to flog?
Mr Gray: It goes back to where we started, which is our duty to customers. Our primary duty is to protect the interest of customers and our predisposition was not to get in the way of a commercial transaction unless we could show that it would have detriment to customers, in which case we should definitely have wanted to get in the way of it. I suppose there is a predisposition not to interfere in this market for ownership of utilities—

Q75 Mr Mitchell: And give it a fair wind.
Mr Gray: —other than wearing our "customer protection" hat.

Q76 Mr Mitchell: You have both been doing a very dapper job in explaining to us that a mess was in fact a thoughtfully considered and carefully worked out mess, but it was really a mess, was it not? Initially you decided that you had to look at maximising benefits to consumers. Then you say that you had to consider there were no disbenefits, which is a change in the whole basis of the thing. Then you find that you cannot prove the figures and you do not have the knowledge and the experience to have any effective control or say, so you hire in £1.3 million worth of consultants to do a job that you should know about in the first place. It does give the appearance that you are being pushed along walking backwards by the National Grid which wants to flog it.

Mr Buchanan: I shall try to answer a whole range of issues there. On maximisation of benefit and no net detriment I shall go back to what I said earlier. Because, under section three, we seek to get the best deal for consumers, we always will do that at price review periods. Under this specific deal, which boringly is called licence condition 29 on the transfer of assets, the clear legal advice to us was no net detriment applied. On timetable, I do not believe that there was a mess on timetable.

Q77 Mr Mitchell: Except a lot of your research papers came out too late to affect the decision. You were providing a lot of information suddenly at the last minute which is too late frankly.

Mr Buchanan: We had 13 consultations through the process, but what in a way I was most pleased that we did was that at two points in the process, one was in November 2003 and the other was in January 2005, we actually reflected that we were listening to consumers and we were listening to various parties who were concerned about aspects of the deal and in November 2003 we put a time delay in so that we could make sure what we were doing was right and that we could stress test the numbers to a level of comfort. Then, in January 2005, we dropped an element of this deal, which was called "exit reform", because we felt we were basically trying to overcook the cake and trying to make it too complex. That is a lesson that we have learned from this process. I feel that we managed, because this is a commercial timetable, and the NAO on page 37 paragraph three very clearly say this is a commercial deal, and we get involved through that licence condition approval that we have to give. In terms of knowledge and experience, I should actually challenge what you say quite strongly in terms of the leadership. We were uniquely lucky to have a lead investment banker looking at what is a very complex corporate deal. Did we have enough of that kind of background? No, we did not. Did we therefore have to go to hire specialists? Yes, we did. At the same time was Ofgem running its business extremely well in terms of financial management? I am pretty pleased about our record over the last two to three years. I should say yes, we were.

Q78 Mr Mitchell: But you keep changing your mind. At the end of the day, with all these consultants, you still got the price 14% wrong because 14% more was paid for it than you expected and the National Grid expected.

Mr Buchanan: In terms of the premia, as Oxera clearly show in appendix 3, the companies paid around 14% but actually it was more like 10%. It is very difficult to draw too much out of premia. If you look at some of the premia in the utility industry, you will see that the German company RWE paid a premium of nearly 30% for a company, Thames Water, and you will see that non-regulated companies typically pay a lot more and there is a table in the Report. I put a circle around a quote this morning on premia that companies pay and this is from Warren Buffett at the weekend. This is where too much is paid for deals. A strategic buyer, if you argue that you are a strategic buyer, is just someone who pays too much. What you cannot ever do is stop somebody paying too much for a deal. If they get their numbers wrong, they get them wrong, but what we know is that at the time of the 14% stress test there were other utility deals. Yorkshire Electricity had been bought by Mid-American—ironically Warren Buffett—at a 14% premium.

Q79 Mr Mitchell: I know some speculators get it wrong. The fact that they were prepared to pay more than you thought, and you indicate they might have got it wrong by overbidding, indicates that they thought that your regulation was going to be too soft and there was a chance of making more profit from it than you were calculating.

Mr Buchanan: I actually think it feeds quite heavily into our argument about there being benefits, because if there were no opex savings and capex savings, but particularly operational expenditure savings, the companies would not be putting that kind of premium down, although, as you see from the Oxera Report, they think it is more like 10%. You would not be putting that premium down. You have to Report to shareholders about your premium and you would not be putting it down unless you felt that there were substantial opex savings to be gained going forward between now and 2023.

Q80 Mr Mitchell: It is difficult to see what those savings would be unless they came from over soft regulation, but at the end of the day, when National Grid got the £5.8 billion, what benefit is that to the consumer?

Mr Buchanan: The ruling that we had to take on this was whether there was a no net detriment from the transfer of assets, which is how we approached this deal. We have identified a benefit for consumers, so that is really how we approach this particular situation.

Q81 Mr Mitchell: What happened to the money? If it was not distributed to shareholders, where has it gone?

Mr Buchanan: Indeed there has been a special dividend at National Grid, but if you go back all the way to 1990, you may not like it, you may like it, but the companies in the utility sector have regularly paid large dividends, special dividends and share buybacks. That may not be something that you particularly like, but it is something that they have done.

Q82 Mr Mitchell: You are certainly right there.
Mr Gray: What you have to remember is that that money came from the buyers. What has happened is that money has come in from buyers, gone to seller and gone out to their shareholders. It has not come from consumers.

Q83 Mr Mitchell: Yes, but you are looking at disbenefits or benefits to the consumer. All this money just flies over the consumer's head: it is not going into his or her pocket.
Mr Gray: The fact that a premium was paid gives us quite important evidence about the sort of cost savings that we can go after in future reviews and if there had not been a premium you would have known there was nothing to go for.

Q84 Mr Mitchell: The National Audit Office has looked at the alternative, which would be not to flog them. It seems to indicate, as I read it, that instead of the largely hypothetical benefits of having more information to make more comparisons, which you say is the benefit from the sale, there will be more real and direct benefits from keeping it operated by the National Grid, for instance £830 million benefit from retention, and deliverable much earlier, deliverable in 2008 as opposed to 2013. What do you have to say to that?
Mr Buchanan: The answer is much as I gave earlier, which is that the figures that the NAO have used on that 3% appear to be reasonable figures to us.

Q85 Mr Mitchell: But the savings would start earlier.
Mr Buchanan: This comes back to your question as to whether you do need to sell them to get the benefits. There is an argument, there has to be, that if you have very, very good regulation and very, very good information and the regional companies of a very large parent company compete very aggressively with each other, then possibly you can achieve the kind of outcome that we think you can achieve better through having comparative regulation with independent management teams going at each other. I do accept that has to be an argument.

Q86 Mr Mitchell: That is provided you have the wit, the staff and the ability to regulate and to know what is going on and you have not demonstrated so far that you have, in the particular way this was done, the benefits of more information.
Mr Buchanan: The only thing I should say is that I would be disappointed if that were the conclusion from the NAO Report because that was not what we had taken from it. I welcome your view.

Q87 Mr Mitchell: You are offering hope rather than dosh. Your costs were about £2.5 million and the Report says, paragraph 3.10, in a statement I cannot quite understand "... added to estimates of additional regulatory costs and offtake costs ... to calculate that net present value of costs resulting from disposals as £100 million". In other words, you have a cost, there are other costs arising, why for a start should the Grid not pay you your £2.5 million instead of you having to run up these costs?
Mr Buchanan: It is a very good question and we gave that consideration, but there is a great danger that you might be seen to be lacking in independence if a company who wanted a corporate deal were willing to pay your costs. That would be a dangerous thing to do.
Mr Gray: We should have been very uncomfortable about coming to you to explain why we had allowed the National Grid to pay our costs in support of their deal. We did think about that quite hard.

Q88 Annette Brooke: Just referring perhaps to the future anticipated benefits, there is a figure on average of a pound per year per consumer which sounds remarkably low in relation to my gas bill. We have this overall figure of £325 million, but what were your calculations of the potential benefits in percentage terms to the average consumer?
Mr Buchanan: It says in the Report, the distribution network businesses only represent a fifth of your gas bill and therefore represent about a tenth of your overall energy bill. When you look at the one pound, you might ask whether that is all you can get, but when you look at some other figures in the Report, apart from the £325 million, you will see 47% savings by 2023 discussed by the NAO. The other issue and one that I have found interesting since being in this job is that when you look at the figures broken down per consumer, it always looks quite different. If I may give you an example, last year we approved an increase in capital expenditure in the electricity networks of £5.7 billion, which is six pence per month on the bill. I always get a little bit nervous when you do bottle it down to the six pence or the one pound. They are important, very important, but when you look at the bigger savings and when you look at that figure of 47%, then it is worth going for.
Mr Gray: The point is that the benefits we have achieved for customers over the last 15 or 20 years from regulation have been the sum of a whole series of relatively small incremental amounts. However, the net effect is that charges have fallen in electricity distribution by about 50% in real terms. The proportion of the gas and electricity bill that is distribution is about 20%, it is about £80. If we had not achieved that saving, it would have been double that and that is made up of a whole series of individual actions that the regulators have taken in the various reviews. If you look at any one of them, you can always do the "But it is only a pound per customer, is it worth it?", but when you do a number of them they add up.

Q89 Annette Brooke: So why did you not take this action earlier?
Mr Buchanan: The answer to that, again it is tucked away on page 37, is that this is a transaction of National Grid and therefore it may well be that the current management team felt that now was the right time to set this transaction in play.

Q90 Annette Brooke: I suppose I am actually coming back to previous questions really. What exactly is your role in terms of the fact that you could have looked at the individual networks, as I understood

your previous answer, and the comparators, but you did not? You are saying it is National Grid's responsibility as to whether they sell or not. Do you not have a responsibility—I am asking out of ignorance here—to check up on National Grid to make sure they are pushing the costs down low enough?
Mr Buchanan: If I go back to 2002, the price review then was done with the national company, Transco, which basically has the big national pipelines and the regional companies and that was done as a job-lot. The following year the price review was then split into the eight regions, so we were working towards a price review for those eight regions before we had done the one-year rollover, which would have occurred in 2007 but will now occur in 2008. That would have been the opportunity for us to look at the individual performance of those eight regions. To go back to the former question, you can put forward a case, it is a reasonable argument to make, that with excellent regulation, excellent information and excellent management teams in each of the eight competing aggressively with each other, which is an interesting concept but let us assume that they do, then possibly you could get to that position. Our experience and the evidence that we gained in this Report suggest to us that going through the independent ownership and structure route will give the consumer a greater chance of getting those benefits, because we will have access to comparative information and therefore I am hoping that we can do that.

Q91 Annette Brooke: But you reached that conclusion quite late in the day. Is that not true? You reached that conclusion quite late in the day in terms of taking that route. Given that your costs were quite high, is there any question of you passing any of those costs of this whole operation back to National Grid before they give their special dividends out to their shareholders?
Mr Buchanan: We did not feel that we could be seen to align our costs with them paying some of the payment because of question marks over our independence on the deal.

Q92 Annette Brooke: Right. That is quite a difficult balance.
Mr Buchanan: It was and we did discuss it at the board and with the audit committee.
Mr Gray: In a way it is the same question: why did they not pay our costs up front? If they knew we were going to pay them later, there is the same potential conflict of them paying for us to do something where we are actually meant to be making a judgment on whether or not they are doing it right.

Q93 Annette Brooke: This is clearly good for the National Grid. Is that sort of balanced judgment on balance good for consumers?
Mr Gray: There are two ways of answering that. One is that in the year in question we managed to accommodate that £2.5 million within our overall budget by phasing work and making sure we concentrated on priorities. We have to do that every year and we try to underspend our budget every year, if we can. So there was no additional cost through us overspending our budget.

Q94 Annette Brooke: But there are transaction costs.
Mr Gray: More importantly in the long run though, the judgment we had to make was whether we thought the benefits we could pass through to consumers would exceed the costs imposed by this deal and the answer was yes. On that basis the correct thing to do for consumers was to allow it to go ahead.

Q95 Mr Davidson: I want to look at the question of safety. Paragraph 6.3 indicates that there had been no major unplanned interruptions. Is that still the case?
Mr Buchanan: As far as I am aware, yes. We have just reached year-end and we shall get that data in shortly.

Q96 Mr Davidson: How do minor interruptions compare?
Mr Buchanan: To the best of my knowledge, and I am still waiting for data, the team has not flagged up to me that there has been a substantial issue there in the past year.

Q97 Mr Davidson: How is the figure of 23,000 reported leaks a year now comparing with then?
Mr Gray: We do not have any data for the period post the sales, because we have just ended the first year, which was the one in which ownership changed.

Q98 Mr Davidson: What would you expect?
Mr Gray: I should not want to express a view for this year. I should expect it to improve in future. One of the others things we can achieve with comparative regulation is better customer service. As well as the cost savings in electricity distribution, where we have been doing this for some time, we have achieved quite substantial improvements in customer service.

Q99 Mr Davidson: Okay, I understand that. So we can expect, if we come back to this in the future, to see a steadily declining number of gas leaks being reported to us. Is that what you are saying to me?
Mr Gray: No, I should not want you to rely on it being steady, because the trend of these things is not normally steady. One of the things we shall be looking at is how to incentivise them to improve that performance.

Q100 Mr Davidson: So there is going to be an unsteady trend then there will be a variable trend, but there will be a discernible trend which will be getting things better and fewer leaks.
Mr Gray: I would expect so, but there is a difference between electricity distribution and gas distribution.

Q101 Mr Davidson: I am not asking you about electricity distribution: I am not interested in knowing the difference.

Mr Gray: I was just drawing an analogy.

Q102 Mr Davidson: I am asking you about gas leaks. Can I just be clear that what you are saying to me is that you would anticipate that over a period, if we come back to this in five years' time, there will be a steady trend with variations indicating a decline in the number of gas leaks?
Mr Gray: Yes.

Q103 Mr Davidson: Fine. We actually accept a yes. A yes is entirely satisfactory, indeed that will possibly come up at your trial in due course. May I just ask, in terms of the other health and safety indicators that you have, that you are working on with the HSE, firstly whether you could just give me an indication of how many there are and secondly whether or not you would similarly expect a trend in the appropriate direction, upwards or downwards, depending whichever is safer?
Mr Gray: Health and safety is very much the responsibility of the Health and Safety Executive. As well as us having to approve the sale and the Secretary of State for Trade and Industry having to approve it, the third party which has to is the HSE. They lead on safety initiatives. It is not our territory, except to the extent that obviously we have to make sure that nothing we do in the price controls prejudices the ability of the companies to do what the HSE wants them to do. However, it is not our job to enforce measures on safety. It is our job to make sure the companies have the money to be able to do what the HSE calls for.

Q104 Mr Davidson: Well that is interesting. So if we saw an increase in lack of safety and it was reasonable to assume that the companies were pursuing financial strategies which resulted in less money being spent on safety measures and there was therefore an increase in those numbers, are you saying in those circumstances you would be absolutely powerless?
Mr Gray: I should imagine that the Health and Safety Executive would want to know from us whether we thought we had done anything which was imposing that pattern of behaviour on the companies. If there were any evidence of that, we would change it. Then it is very much for the Health and Safety Executive to set the targets.

Q105 Mr Davidson: Let me be clear. If the companies find themselves in a position where the number of health and safety breaches is increasing, a plausible defence for them is to say that they cannot afford to do it because you are squeezing them too tightly.
Mr Gray: Yes, they might say that.

Q106 Mr Davidson: Presumably you have taken all that into account. It seems to me that would be the first refuge of somebody who wanted to increase their profits in some way by simply arguing that they were being squeezed so tightly that they could not afford to maintain the service.
Mr Gray: The industry blames all sorts of things on us of that sort, but in the end they have quite strict legal and licence obligations to maintain satisfactory levels of performance. If they were breaching those licence obligations, then either they would be in breach of something the HSE had imposed and they would take action on it or, if it were a breach of the licence for which we were responsible, we should take enforcement action on that.

Q107 Mr Davidson: I take it you could reassure us that you would not fall for that one, if they simply argued that you were being far too tight on them financially and that was why the number of accidents was going up.
Mr Gray: In all regulated businesses there is always a discussion around the service required out of these companies. One of the services required is a very great focus on safety.

Q108 Mr Davidson: In terms of the service you require, I notice that in the bad old days it was going to take 51 years to replace all the at-risk pipes, and that is down in paragraph 6.4, and now in the bright new dawn it is going to take 30 years to replace all the pipes at risk. If my house were one of the ones which were not going to be dealt with until 29 years and a bit from now, I am not sure I should regard that as all that much of an improvement, would you?
Mr Gray: That arrangement whereby the pipes were to be replaced was one which was agreed between HSE and Transco as it was then. Our role in it was simply to ensure that the industry has sufficient funds to make sure that it could replace the pipes on the agreed timescale. We took action in the last price control review.

Q109 Mr Davidson: This is the "It's nothing to do with me guv" effect, is it?
Mr Gray: It is very much to do with us in the sense that we have to make sure they have the money.

Q110 Mr Davidson: Are you happy then with a position where these pipes which are potentially dangerous only have to be replaced within 30 years?
Mr Gray: It is not our responsibility to judge the period over which it should be done.

Q111 Mr Davidson: That is the "It's nothing to do with me guv" effect, is it?
Mr Gray: It is just a question of who is responsible for what in this kind of situation. It is not our responsibility to set the safety measures.

Q112 Mr Davidson: You have accepted a position where the HSE and the companies have settled on 30 years and you have taken the view that is not something you would intervene in or express a comment on, you just take that as a given. Is that correct? We will settle for a yes.
Mr Buchanan: Yes. The HSE have set that parameter and we have a very close working relationship with them.

Q113 Mr Davidson: Fine. I just want to be clear about who is responsible for that. May I turn now to the question in paragraph 6.11 of extensions to the gas network? I wonder whether or not this is all somebody else's fault as well. I should have anticipated that there would be some pressure under any new regime to improve the extension of the gas network beyond that which was there before, rather than simply leaving it as it was previously. The fact that it indicates here " . . . expected to have a neutral impact on the number of extensions" indicates to me that there is an opportunity missed. Is that fair?
Mr Buchanan: You may regard this as good news: this is something we are going to be addressing and there will be a consultation paper out shortly as part of the price review we are doing. This is almost a classic example of what you can do in a corporate transaction or what you can do when it is your turn. Our turn is in the price reviews and we are going out to consultation on some of the issues which should potentially be looked at with regard to the extension of the gas networks.

Q114 Mr Davidson: What position will you take going into this? You do not walk into this with no idea whatsoever.
Mr Buchanan: That is a very good point. Our opening position is largely covered by what is called section 4A of the 1986 Gas Act, which says that we have to look at situations where it is reasonably economic and therefore we shall have to make a judgment in the light of the consultations as to whether it is reasonably economic. One of the examples on which we may get feedback is that there is a ten-metre free rule, but if you are more than 23 metres away from a gas main you lose that. Is that fair? Should we revisit that? Those are the kinds of things we want to revisit in the consultation and should welcome your views on this.

Q115 Mr Davidson: A consultation like that is likely to be dominated by those who would gain by the extension.
Mr Buchanan: As regulators we are pretty cynical as to where people are coming from. May I give you comfort that we are cynical?

Q116 Mr Davidson: I just wonder whether my urban constituents would be yet again forced to subsidise farmers, who in my view already get far too much. Is that a fair way of seeing how the thing could progress?
Mr Buchanan: At the moment I do not want to prejudge it because we are opening up the issue for discussion. I very much welcome your views on it.

Q117 Mr Williams: This question of leaks and replacement of pipes. The 23,000 leaks a year, most of which are minor, represent over 60 a day, which is a surprisingly large number. When you think of the number of customers, if it is all tiny household leaks, it could be seen in a different perspective. Looking at paragraph 6.4, a point is made that over a five-year period to 2001 an average of 1,840 kilometres a year of at-risk pipe were replaced, that is 1,150 miles. Let us stick to miles—I am not metricated. You were replacing 1,150 miles a year of at-risk pipe, which means that if it were going to take 51 years that would be 58,000 miles of pipe at risk. If we look at paragraph 6.2 and turn the kilometres back into miles there, that means that one third of the existing network is regarded as at risk. That is staggering, is it not?
Mr Buchanan: It is very serious quite clearly.

Q118 Mr Williams: Not just serious, but very serious.
Mr Buchanan: Yes, very serious.

Q119 Mr Williams: What now is intended is that you replace within 30 years, but in 30 years it would mean you would have to replace at the rate of 2,000 miles a year. Right?
Mr Buchanan: Yes.

Q120 Mr Williams: Double the previous. Were the companies aware of this when they took on the four sold-off areas?
Mr Buchanan: Yes.
Mr Gray: Yes, they were aware of the arrangement.

Q121 Mr Williams: Which were they aware of? The earlier set of figures or were they aware of the doubling?
Mr Gray: They were aware of the new arrangements. The 1,150 miles a year was the performance before the 2001 price review. The accelerated replacement was introduced at that price review with funding to allow the companies to do it.

Q122 Mr Williams: What estimate of annual cost is there to replace 2,000 miles a year?
Mr Gray: The mains replacement programme, which is part of the expenditure the companies undertake, which is specifically to do with this, runs at about £430 million per annum in the current five-year period. That is one of the largest bits of expenditure.

Q123 Mr Williams: That is £430 million a year to replace pipes.
Mr Gray: Yes.

Q124 Mr Williams: That is over the whole network, not just the four.
Mr Gray: That is over all eight DNs.

Q125 Mr Williams: So the four who purchased got approximately half of that to pay.
Mr Gray: Yes.

Q126 Mr Williams: That cost is obviously going to go to the consumer, is it not?
Mr Gray: Yes.

Q127 Mr Williams: It is quite a considerable sum. How much of it is in urban areas? If we have 58,000 miles of pipe at risk, how much is in the urban areas where it is very expensive?

Mr Gray: I should guess—and I should be guessing because I do not have the data—that probably the large majority of it would be in urban areas because those are the areas where the system is overridingly post-war cast iron pipes.

Q128 Mr Williams: We have three types of pipe: there is the original cast iron pipe which was used from the beginning of the last century and which, understandably, is subject to corrosion, but there is a degree of predictability about it. Earth shifting is a different matter. Then, in 1970 you moved to this ductile iron pipe. Were you using that to replace the old?
Mr Gray: You keep saying "you": it is the industry.

Q129 Mr Williams: You embody the industry for us today.
Mr Gray: We embody consumers actually.

Q130 Mr Williams: Yes, you are supposed to be looking after the interests of consumers. It says here that the safety of consumers is a major consideration. I would have thought that physical safety must be a predominant consideration. If we look at footnote 35 we find that the ductile iron pipe was introduced in 1970, but this now presents a different type of problem, does it not? According to this, it fails unpredictably. How much of it is down there and do you have to dig it all up again?
Mr Buchanan: The best thing is for us to get that data for you in the breakdown of cast iron/ductile iron pipes.

Q131 Mr Williams: In terms of priorities, has it meant there is a shift in priority? From the 1970s on you have been putting in this new type of piping. Do you now have to say, because it is unpredictable . . . I assume a lot of it will be in areas where there are new housing estates, so following the housing explosion—excuse the rather inappropriate phrase at the moment—since 1970, a major part of this ductile unpredictably volatile pipe will be in new housing estates.
Mr Buchanan: Yes.

Q132 Mr Williams: Have you stopped using it?
Mr Buchanan: It is a great question and the HSE clearly set the parameters, but the important thing here is that we do represent the consumers we do not represent the companies.

Q133 Mr Williams: Have they stopped using it?
Mr Buchanan: We do interface on this. The companies have a primary responsibility to make sure that the pipes are protected and that they have the appropriate assets in place. If we were to set a price review which in their view was thoroughly irresponsible, they would go to the Competition Commission; they would have to.

Q134 Mr Williams: Coming back to the fact that you are looking after consumers' interests, we understand that, but if you are not asking the questions I am asking, it seems to me there are some important questions you should have asked. So it is not unreasonable to ask you which is the greater priority, replacing the newer ductile unpredictable iron pipes which are substantially in new urban areas, or replacing the old cast iron pipes?
Mr Buchanan: It is a very reasonable question. To give you some kind of comfort, through the price control discussions we have—so for the price reviews this year it is largely with National Grid, Scottish Power and Scottish Hydro—we have regular discussions on the quality of the assets, we hire engineer consultants to go out and look at the quality of the assets, we have intense negotiations with the companies on the quality of the assets.

Q135 Mr Williams: This is waffle. You are missing the point.
Mr Buchanan: We have their asset register. We will then negotiate with them, effectively on the back of the advice of the engineers and the HSE—

Q136 Mr Williams: I am sorry, but you are misunderstanding the question. The question is not what you are negotiating about. The question is: since consumer safety is your priority, what attention are you paying to the new and more dangerous problem of a pipe having been used for new developments which is actually more volatile and unpredictable than previous piping? You are not able to tell me what priority there is now in replacing pipes, whether you are still concentrating on the post-1900 stuff up to 1970 or whether you have had to switch to replacing the new and using the third type, the plastic pipe, to replace it.
Mr Buchanan: Quite clearly our primary responsibility is as an economic regulator and we look to the specialists at the HSE with their primary duty, but also, when we are in a price review, to the specialist engineering consultants. In answer to the questions you ask, I want to give you some confidence that we do ask them but the degree of responsibility—

Q137 Mr Williams: But you do not remember the answers.
Mr Buchanan: I can give you an example right now. We are going through the electricity transmission price review and we are analysing the underground cables, we are analysing the quality of the overhead wires and we have engineering specialists to help us do that. I want to give you some comfort that it is not just ignored.

Q138 Mr Williams: I should like you to look at the questions I have asked. I may consider putting in some written questions to refine them.
Mr Buchanan: We should welcome that and we shall try to give you some answers.

Q139 Mr Williams: I should like a full report from you for us to embody in our Report on this issue of safety, the extent of it, the location particularly, since a lot of the new stuff will be in urban areas and so on. I shall probably put together a set of questions and pass them in, but read what I have said in my questions.

Mr Buchanan: Yes.

Chairman: That concludes our meeting. Just to sum up, the Report estimates that there are potential savings for the consumer of £1.2 billion between 2008 and 2023. Some of us will not be here in 2023, so we hope you make more progress before then. Thank you very much.

Supplementary memorandum by the Office of Gas and Electricity Markets (Ofgem)

On 8 May 2006 Alistair Buchanan, Chief Executive, and David Gray, Managing Director, Networks, Ofgem, gave evidence to the Committee of Public Accounts. During the course of the evidence session several questions were asked about safety issues relating to gas pipes. This supplementary memorandum contains further background information which Mr Buchanan offered to provide to the committee.

Some of the points raised in the meeting are properly a matter for the Health and Safety Executive (HSE). This memorandum, therefore, sets out the statutory responsibilities of the HSE, the network operators and Ofgem; factual information about the gas distribution networks, including the breakdown of pipes and interruptions in supply; and details of the regulatory framework for gas safety which is administered by the HSE. The following information has been shared with the HSE.

Roles and Responsibilities

The network operators have comprehensive duties under the Health and Safety at Work Act 1974 and regulations made under it. These duties are designed to secure the health and safety of their employees and all others persons who may be affected by their work activities, including the general public.

The Health and Safety Executive (HSE) has primary enforcement responsibility for gas safety. The HSE administers an established regulatory framework in which each network owner is required to prepare a Safety Case showing how it is safely managing the conveyance of gas. This will include arrangements for managing its mains replacement programme. Each Safety Case has to be accepted by the HSE before gas can be transported; and a Safety Case is also required from the Network Emergency Co-ordinator (NEC) who has overall responsibility for co-ordinating emergencies across networks. The HSE reappraised its Safety Case processes after the announcement by National Grid of its intention to sell some of its distribution networks. The new network operators submitted safety cases to the HSE, which were accepted. Subsequently the HSE have prepared an inspection programme for each operator, which includes checking compliance with their mains replacement programme.

The Gas and Electricity Markets Authority has statutory responsibilities under Section 11 of the Utilities Act to consult the Health and Safety Commission about all gas safety issues which may be relevant to the carrying out of its functions and to take into account any advice given by the Health and Safety Commission about any gas safety issue. Ofgem has a Memorandum of Understanding with the HSE, which sets out the general arrangements for achieving co-operation and the exchange of information and effective consultation between both parties.

Britain's Gas Pipeline Infrastructure

The table below shows the total population, in kilometres, of Cast Iron (CI), Spun Iron (SI) and Ductile Iron (DI) mains of varying diameter for each GDN: East of England, London, North West, West Midlands (all owned by National Grid Gas plc), North of England (operated by Northern Gas Networks), Scotland, South of England (both operated by Scotia Gas Networks plc) and Wales and the West (operated by Wales and West Utilities).

	NGG				*NGN*	*SGN*		*WWU*	
2005–06	*EoE*	*Lon*	*NW*	*WM*	*NoE*	*Scot*	*SoE*	*W&W*	*TOTAL*
CI (> 12″)	269	888	971	533	253	221	823	1,389	5,348
CI (< = 12″)	5,900	6,224	8,606	6,709	3,733	4,166	10,185	2,988	48,511
SI (> 12″)	351	81	117	145	341	165	242	1,043	2,485
SI (< = 12″)	7,537	1,425	1,947	1,907	7,114	2,117	6,380	3,560	31,987
DI	2,824	1,809	1,681	1,335	3,646	948	1,848	2,469	16,559
TOTAL	16,880	10,427	13,322	10,630	15,086	7,618	19,479	11,449	104,891

Interruptions in Gas Supply

Ofgem collects data from the gas distribution network (GDN) owners on the number and duration of non-contractual interruptions which occur on each of their networks. Annual data for the 2005–06 regulatory year is due to be submitted to Ofgem by 31 July 2006. To date, however, Ofgem has received notification of the following major interruptions (where loss of supply occurs to over 250 supply points):

Date	*Location*	*Cause of interruption*	*Supply points affected*
06/06/05	Chingford	Third party damage	583
24/08/05	Grassmoor	NGG initiated	1,233
23/11/05	East Grinstead	Water ingress	390
31/01/06	Romford	Water ingress	400 (an additional 1,500 experienced pressure problems)
01/03/06	Marsden	Broken main	2,000
22/03/06	Henham & Elsenham	Third party damage	1,200

Mains Replacement Programme

In September 2001 the HSE published its enforcement policy for the replacement of iron gas mains for the period 2002–07. The HSE considered that it was realistic and practicable for GDNs to speed up their annual rate of mains replacement over the next five years in order to replace within 30 years all pipes designated "at risk"—defined as the iron pipes within 30 metres of buildings (the 30/30 programme). This enforcement policy has been updated ("HSE's Enforcement Policy for the Replacement of Iron Gas Mains 2006–13") following a review in September 2005 ("Review of HSE's Enforcement Policy for the Replacement of Iron Gas Mains"). Under the Pipelines Safety Regulations 1996 (Regulation 13A), HSE approve annual replacement programmes for each of the network operators. The iron pipes specified in Regulation 13A of the Pipeline Safety Regulations would include wrought iron, spun iron, ductile iron and cast iron pipes.

The table below shows the length of mains to be replaced under the HSE's enforcement policy and the length of the total mains population. This data has been provided to Ofgem for each GDN. It should be noted that under the HSE's enforcement policy all iron mains within 30 metres of premises at present amounts to 102,000km of mains (38.8% of the total mains population).

2005–06	*EoE*	*NGG Lon*	*NW*	*WM*	*NGN NoE*	*SGN Scot*	*SoE*	*WWU W&W*	*TOTAL*	*%*
HSE Enforcement Policy Mains (km)	16,919	10,742	13,152	10,267	16,390	6,802	18,188	9,409	101,869	38.8
Total Mains Population (km)	46,504	21,916	33,496	21,575	35,500	23,972	47,546	31,990	262,499	

Prioritising Mains Replacement

During the evidence session on 8 May, concern was expressed about the relative risk associated with different types of iron pipes, and the impact this should have on the prioritisation of mains replacement.

The risk associated with individual mains that fall within this policy varies by several factors including material, location, and history of leakage. On the particular question of ductile iron pipes, the HSE required Transco to decommission all medium pressure ductile iron (MPDI) mains within 30 metres of property by 30 April 2003. We understand from the HSE that this resulted in excess of 2,800 km being decommissioned; that serious concerns remain about the integrity of MPDI mains; and that any additional lengths which are found or become "at risk" must be replaced as soon as reasonably practicable and in any case within 12 months of being found.

GDN operators should set out their policy and procedures in their Safety Case for implementing and managing their mains replacement programme to meet the objectives of this policy. These arrangements should include how the annual replacement programme is prioritised. The criteria for establishing the replacement programme should meet the requirements in the HSE's Gas Safety (Management) Regulations Safety Case assessment manual.

The methodology of prioritising mains replacement has been agreed with HSE and is based on developing replacement projects around the higher risk mains such that they are targeted earlier in the programme. However, HSE accepts that an appropriate balance has to be struck between operational efficiency and risk reduction and will accept alternative methods of prioritising replacement. However, this requires operators to demonstrate that an equivalent amount of risk will be removed. In reality, changes in the method of prioritising replacement has resulted in much larger replacement projects, delivering economies of scale, a potential shortening in the 30 year programme and a significant reduction in disruption in the networks.

It is expected that the number of leaks from the networks will fall over the next five years and further over the full 30 years of the programme. It is unlikely to be a linear reduction, due to the large main and service populations involved and the relatively low proportion to be replaced each year, but a downward trend is expected.

Monitoring Performance

Ofgem were involved in discussions with the HSE in 2001 to help formulate an efficient, economic and practically viable length of the programme.

Ofgem's principal involvement relates to the funding of the work. We agreed that if the HSE require the GDNs to accelerate their current mains replacement programme we will adjust their price control to allow for this. We will assess whether any additional costs associated with HSE requirements are efficiently incurred, and the overall cost and impact on customers.

The HSE review the mains replacement programme performance with each GDN individually. The HSE will monitor the performance of GDN operators in meeting replacement targets in accordance with HSE document "Monitoring and reporting of the Distribution Networks' Mains Replacement Programmes 2006–13". This updates an earlier document covering the period 2002–07 and covers Ofgem's next price control review period 2007–13. The HSE keep Ofgem informed of progress of this and other safety related issues in regular meetings.

Supplementary memorandum in reply to Kitty Ussher MP

Your note referred to Ofgem's decision to postpone the next five-yearly gas distribution price control by one year to March 2008. You raised the possibility that National Grid's costs may have come down further than we expected in the current price control period; that we would not be aware of this because of a postponement of the next review; that buyers of the distribution networks (DN), on the other hand, would be aware having seen the evidence in the data room; that they would then pay a premium for the DN in order to enjoy a further year under the existing price control; and that the benefits would be passed on to shareholders at the expense of consumers.

I know that you have looked into this issue in detail and you have pointed out a genuine risk. I would like to take this opportunity to explain the background to the next price control, Ofgem's analysis of the risk to which you referred, and the steps we are taking to protect consumers.

As you know, the main mechanism through which Ofgem regulates the monopoly gas distribution networks is the five-yearly price control reviews. The decision to delay the gas distribution review followed a consultation we conducted in 2003 which led us to propose a number of changes in timetable for future reviews. This arose from the merger of National Grid Holdings plc and Lattice plc (the owners of the electricity and gas transmission systems respectively) which suggested that there would potentially be significant benefits from reviewing all the transmission licensees in a single review. As a result, the full reviews for the Scottish electricity transmission companies were delayed by two years and that for National Grid by one year. At the same time, we felt there would be benefit from conducting the gas distribution review separately from gas transmission. This rescheduling of reviews also had the advantage of providing a more balanced workload for the industry and for Ofgem.

One of the key questions arising from this change, which you picked up on in your note, is what happens in the period of the one year control. I can reassure you that the existing price control is not simply continued unchanged for a further year. A new price control will be put in place in the year 2007–08. In the interests of proportionality, the associated review will not examine the companies' costs in quite the same level of detail as if we were setting a five year control. This is because the companies need to do a lot of work to assemble the information we need to set a price control and, given that it is only for one year, in the interests of better regulation we do not want to place a disproportionate burden on the companies. However, we will still carry out a careful and thorough cost analysis. If we assess that the gas distribution companies have driven down costs further than originally expected, we can take that into account and set a lower allowance for that extension year. If there are specific issues of uncertainty that cannot realistically be resolved until the main review, we can make a provisional decision and make clear that we will apply a correction factor in the light of evidence assessed in the main review.

Having said that, there must still be a risk that the price control for the extension year may prove, in the light of evidence arising at the main review, to be too generous. Our assessment, however, is that this risk is outweighed by other factors. First, staggering the reviews allows us to have a proper focus on distribution, separate from the transmission review. This should, in itself, provide opportunities to achieve greater benefits for consumers. Second, delaying the main review by one year will allow us to take into account data for 2006–07, the first full year in which the DNs will be in separate ownership. A five year control taking effect in April 2007 would have had to be based on financial data for 2005–06, the year in which the transaction completed. Data for that year is unlikely to provide much useful information on the approach of the new owners and might well be distorted by the sale process itself. We therefore judged that a review conducted in 2007–08, based on data for 2006–07, was in fact more likely to provide evidence that would be to the benefit of consumers than a full review conducted a year earlier.

This raises a separate question which you rightly asked in the evidence session itself: could we have achieved the benefits of comparative regulation and avoided the above risks if the DN sales had not taken place at all? Would the separation of the DNs into regional business units, under the same owner, have been sufficient?

The ability to make comparisons drives customer benefits in two key ways. First, it generates comparative information that the regulator can use to set more challenging price controls as a result of reduced information asymmetry than would otherwise be the case. Second, it introduces new management teams, and therefore the potential to increase efficiency savings by (a) generating greater innovation within the industry, (b) facilitating the transfer of best practice and (c) allowing economies of scope to be captured with other utility networks owned by the same corporate group.

Separating the companies into regional units gives you some of the benefits of comparative information but not of new management. Our experience in the electricity sector, where we have 14 DNOs but only seven ownership groups, suggests that evidence derived from the actions of separate management teams (rather than just additional comparative information) is an important driver of customer benefits. Differences in performance between the licensees under common ownership may simply reflect internal cost allocation rather than any real difference in performance. However, as we could not say for certain the extent to which benefits would be the result of information or management behaviour, our analysis included a scenario where a higher proportion of additional efficiency savings was attributed to the introduction of separate price controls for each regional DN—ie a higher proportion of additional efficiency savings (and hence customer benefits) were assumed to be achievable regardless of whether sales occurred. This is the low case in the Final Impact Assessment.

Alistair Buchanan
Chief Executive

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