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Dear ,

Acceptance of Standard Condition 4C Methodologies

The letter from Rachel Gutman (Ofgem) of the 15 November 2001 set out a proposal to introduce interim arrangements for SLC4C approvals until a wider review of charging matters was completed. The interim measures would affect all applications received after the 7 December 2001. Comments on the letter were requested by 30 November 2001.

There were a number of detailed responses and questions relating to the proposal. These have now been considered and the final decision with respect to the interim arrangements is explained below.

Timing of the interim arrangements and the Gas Act duty to ensure that a licensee can finance its activities

Two IGTs suggested that the relatively short period before the introduction of the interim arrangements could have serious implications as they had already quoted prices to developers on the assumption that the charging arrangements would be approved under SLC4C. It was also suggested that this might create a conflict with Ofgem's duty to ensure that a licensee can finance its activities.

Ofgem's principal duty is to protect the interests of consumers. The implications of giving an acceptance under SLC4C, that charging arrangements might be in place for twenty years, are serious enough to warrant interim procedures being put in place. If the wider consultation process reveals that a different approach is more appropriate then changes could be made to any charges approved during the interim period.

If a licensee can demonstrate that a specific commitment made prior to the 15 November is such that the interim arrangements present a significant threat to its financial viability then it would be appropriate to consider whether those circumstances justified a different approach.

That there had been inadequate information regarding the rationale for the imposition of the interim arrangements

Two IGTs considered that Ofgem had not provided sufficient rationale for the imposition of the interim arrangements.

The charging arrangements and activities of certain IGT's have given rise to a range of concerns.

- ◆ The 15 November letter explained that earlier this year IGTs were required to provide information on the rates of return associated with gas transportation charges. This data revealed a wide range of prospective returns across the sector. It is not clear whether these differences relate to efficiency or the exercise of monopoly power and suggest the need for further investigation.
- ◆ In May 2001 Ofgem published a review of competition in the markets for connections. This document noted that the activities of certain IGTs appeared to be distorting the development of competition in the provision of connections.
- ◆ As noted in the review of competition for domestic consumers published in November 2001 suppliers have reported difficulties and concerns in dealing with consumers on IGT networks. As a result, some suppliers have or are considering increasing prices to consumers on IGT networks.
- ◆ Energywatch has expressed concerns with respect to the operation of IGTs and suggested that they should be regulated in a way broadly consistent with other energy networks.

Therefore a relatively wide range of evidence suggests possible difficulties with existing arrangements for the regulation of IGT charging. The present processes are such that Ofgem is expected to approve charges for a period of up to twenty years. This is materially different to the other charge restriction conditions in gas and electricity licences and it is the combination of these factors that makes interim arrangements appropriate.

That Ofgem did not have the legal vires to impose such interim measures upon the industry

One respondent said that Ofgem does not have the vires to change the way in which it had been processing acceptances before a consultation process. Another respondent said that Ofgem does not have the power to stipulate prices that may be earned through a charging methodology.

Given that the proposals are for interim arrangements, that the notion of a review of IGT charging arrangements was consulted on in 2000/01 as part of the process for developing Ofgem's corporate plan for 2001/02, that charging arrangements can last for up to twenty years and the rationale set out above, then the approach that has been adopted is appropriate and reasonable. Further, assessing charging methodologies and deciding on whether to grant approvals on the basis of the level and structure of the transportation charges appears both reasonable and consistent with Ofgem's statutory duties.

That Ofgem has not considered the cost reflectivity of Transco's charges prior to imposing its interim proposals

Two respondents said that Ofgem had not considered whether the charges levied by Transco to the CSEP were cost reflective. Other respondents said that Transco's charges were not a relevant benchmark to compare SLC4 charges.

Ofgem has considered Transco's LDZ and CSEP administration charges. In 1999 Ofgem consulted on LDZ charging and also undertook an investigation of the CSEP administration charge (which resulted in a significant fall in this charge). The consultation considered whether Transco's LDZ charges could be made more cost reflective. It concluded that the cost of moving away from the postalised charging to a more cost reflective approach would involve significant administrative costs for both Transco and the shippers. However, it also concluded that charging to CSEPs could be improved and Transco has subsequently adjusted its charging methods to reflect these suggestions.

The advantages of using Transco's charges as a benchmark against which to judge IGT charges is that suppliers and shippers would not face additional transportation in serving consumers on IGT networks. This would encourage competition in the supply market and prevent extra costs being passed on to consumers. In addition it would promote efficiency on the part of IGTs and provide a simple and transparent approach to regulation.

That competition in gas transportation and gas connections will be severely effected by this change

One IGT suggested that competition in gas transportation would be severely effected by the interim procedures. Another IGT commented on the implications for competition in gas connections.

Gas transportation is a monopoly activity and the operation of SLC4 does not appear to provide effective competition in network operation.

As noted above charging methodologies designed and accepted under standard condition SLC4C have had the effect of distorting competition in gas connections. The interim proposals would not make this situation any worse and may reduce some of the present distortions.

The Way Forward

In the light of the above discussion it is clear that the interim arrangements outlined in the letter of the 15 November 2001 remain appropriate and they will be introduced for all applications received after the 7 December. A consultation paper on SLC4 charging arrangements will be published in January 2002 with the intention of finalising any associated changes to IGT charging arrangements later in 2002.

The interim arrangements are such that acceptances will only be given to SLC4C methodologies if they meet the following conditions:

- (a) the charging methodology must include a constraint such that the total charge for each site – derived from both condition 4 and condition 4C charging methodologies – is no more than the Transco equivalent ‘all the way’ charge; and
- (b) where the Transco equivalent all the way charge – is shown by calculation of the charges to an equivalent nearby postcode to the site in question; and
- (c) where all the assumptions used to derive the charges and demonstrate compliance with (a) and (b) are provided and set out in a transparent and easily understood manner; and
- (d) the charging methodology will allow Ofgem to request and receive a charging report up to once a year during the life of the project, this report will update the information provided under (b) and (c) above.

Charges should be based on the standard AQ. In subsequent years they will be allowed to vary with changes in the retail price index. Therefore, the interim arrangements will not require charges to be changed to reflect future movements in Transco’s charges.

Approvals for charging methodologies that do not comply with these conditions will only be given in exceptional circumstances, such as for certain rural infill projects.

It is important to stress that these are only interim arrangements and will not prejudice the wider review of these matters that will take place during 2002.

Yours sincerely

Andrew Walker
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