12 Feb 2003

SP GAS LTD

Submission on Ofgem Consultation Paper on Independent Gas Transporter charging – Draft Proposals December 2002 87/02

A. Introduction

The Consultation Paper seeks views on the draft proposals for relative price regulation and other issues identified for consultation. In this regard SP Gas has also considered Ofgem wider review of IGT's charging arrangements specifically - consultation on "Independent Gas Transporter Charges and Cost of Capital dated February 2002" and subsequent "Ofgem letter dated 12th November 2002." In summary:-

(a) SPG believes that the suggested approach by Ofgem on establishing the cost of capital described in the Cost of Capital consultation in February 2002 and 12 November 2002 is inappropriate and underestimates the true cost of capital for an IGT.

(b) a more appropriate mechanism to protect the interests of customers and to ensure that IGTs do not earn more than "a reasonable profit" under SLC4, would be to impose a price cap on IGTs transportation charges, capping their charges, year on year, at the same price cap as Transco's transportation charges. This protects consumers by ensuring they are not charged more than they would be if Transco were the sole transporter and at the same time would encourage competition by allowing IGTs to finance their activities and thereby allow them to compete on a level basis with all licensed Gas Transporters including Transco.

SP Gas currently have an approved methodology under SLC 4 which exactly mirrors Transco's equivalent charges and are therefore regulated under SLC 4 by the use of a self imposed price cap which taking one year with another do not earn more than a "reasonable profit."

SP Gas does not support Ofgems proposal to alter its current methodology to a regulator-defined "reasonable profit" measured over a short period. This conflicts with SP Gas's business objective under its current accepted methodology which avoids price spikes, promotes competition between shippers, protects consumers and returns and reasonable profit over the long term. In SP Gas's view, as a direct result of Ofgems proposal, potential IGT's investors will be dissuaded from participating in the market resulting in fewer IGT's.

Conclusions

SP Gas would request to be governed under relative price regulation with immediate effect for legacy and new projects and consider this to be achievable on voluntary basis under current licence conditions.

As can be seen from the above and in SP Gas's response to "Gas Transporter Charges and Cost of Capital dated February 2002" and response to "Ofgem letter dated 12th November 2002", (copies attached) prescribing a WACC presents many difficulties to SP Gas, in methodology changes, compliance with Ofgems WACC determination, application to the market (shippers) and in honouring existing commercial contracts secured on the basis of matching Transco equivalent charges.

SP Gas wishes to retain its existing methodology, which is approved by Ofgem and, it believes, complies with current SLC4. Prescribing a fixed WACC to this methodology is therefore inappropriate since it mirrors Transco equivalent charges. With a cap on charges set at Transco existing price cap, consumers are protected and IGT's, derived from the available

Transco equivalent income, will be free to structure their finance to reflect their actual cost of capital, business operations over the long term, enable IGT's to continue to expand in the market and result, taking one year with another, in a "reasonable profit" under SLC 4. This is SP Gas's current accepted methodology under SLC 4 as accepted by Ofgem.

As stated, SP Gas would therefore formally request Ofgem to consider exempting IGT's with a methodology which is based on the variable Transco matched income levels, from moving towards a revised methodology containing an Ofgem determined rate of return, measured over short term scales, applied to it.

B. Comments in Support of Relative Price Regulation

SP Gas agrees with Ofgems proposal to move to a common charging calculator for use by all IGT's and shippers involved in validating charges for transportation services. SP Gas believe implementation of relative price regulation can be implemented seamlessly to all Transporters for legacy projects and new projects with the possible exception of the four IGT's who Ofgem have shown to charge between 150 and 200% of Transco equivalent charges.

It is anticipated Ofgem will require further negotiation to migrate these companies existing projects to relative price regulation however, SP Gas see no reason why any new projects cannot be governed by relative price regulation with immediate effect. SP Gas would be prepared to move to relevant price regulation on a voluntary basis for legacy and new projects with immediate effect and then be governed by licence changes when implemented.

Attached is a presentation detailing the simplicity of calculation of Transco's equivalent charges for reference, and undernoted is the key rationale, currently used by SP Gas under its existing approved methodology in its application:-

Charges to site level or property level.

SP Gas have implemented the charges at a property level due to ease of calculation since property level AQ's are held and communicated to Transco on a weekly basis under the current Nexa agreement. All details are therefore held under contract for capacity booking and therefore "double" to facilitate IGT charging at a property level.

In addition, charging to a "property" level promotes competition between shippers/suppliers and protects consumers.

The alternative application of a site charge results in an average charge applied to all houses no matter what their predicted consumption is, therefore on a mixed development of 4BD and 2BF, the 2BF will incur a higher charge and the 4BD a lower charge than Transco equivalent. Shippers/suppliers are therefore incentivised to cherry pick customers in large houses and ignore smaller houses.

✓ Charges should be applied to a site level to protect consumers and promote competition between shipper/suppliers.

Nominated AQ

SP Gas currently applies the shipper nominated AQ for billing purposes. The underlying consumption profile (ALPt) is used to determine the predicted consumption of each house type during each month of the year. The result of this is:-

a) Transco equivalent charges are reflected based on the underlying predicted consumption
b) Shipper to Shipper transfers are encourages at any time of the year. Should a flat charge be made, shippers will gain a windfall of reduced charges in the winter months and incur additional charges in the summer months, therefore shippers are incentivised to campaign to recruit in the winter months only and the incumbent shipper/supplier incentivesed to delay transfer.

- ✓ Charges should be applied to reflect the underlying consumption profile and thus promote effective competition between shipper/suppliers.

Under network code shippers can re nominate AQ's based on validated meter reads. Under the Nexa, IGT must communicate the revised volumes to Transco for their billing purposes, therefore IGT currently hold data on the predicted and actual AQ's to satisfy contracts/Network Code.

The risk of the re nomination should be borne by the IGT. Under the current arrangements, IGT's and indeed house builders have opportunity overestimate the house types at the outset of projects and hence gain additional revenue from shipper/supplier/consumers over what a Transco equivalent property.

Placing the risk of the consumption with the IGT will continually focus the IGT's on efficiencies and co-operation with the shippers in validation of meter reads. Under relative price regulation AQ's should be a risk the IGT's factor into their bidding process and/or rate of return.

- ✓ IGT's should be incentivised to continually ensure AQ's are correctly stated. Re nomination of AQ's can only be effected going forward. This is because reconciliation across Transco's formulas, taking account of weather corrected data etc. is virtually in-calculable.

Mechanics of calculation of the charge

- ✓ The mechanics of calculation of Transco's charge is well established and used by all Shippers / Suppliers in validation of invoices. The attached presentation of applying the charges provides a worked example.

Principles for selecting RPC approach – Preferred approach.

SP Gas supports the year on year migration of each IGT's portfolio of customers to the current applicable Transco charging calculator. This provides a simple validation and application of billing for Shippers and Transporters. The calculation and application of charges is therefore market validated by the shippers and requires no regulatory involvement.

To provide security of investment SP Gas recommend application of the above in perpetuity with a minimum floor price of no more than 1% reduction from the previous years average charge. Should charges be calculable from Transco equivalent <u>at less than 1% from the</u>

previous year, then this amount will be calculated and continually added to IGT's invoices until such time as Transco's equivalent charges fall within the minimum year on year reduction level. – *This is the only deviation from SP Gas's existing methodology*

- ✓ On going (year on year) migration and calculation of charges equivalent to Transco provide the industry with a simple, and importantly, a common calculator providing ease of application, validation and auditing. This provides for an in perpetuity solution with no regulatory reviews other than to police application of the methodology.
- ✓ Calculation of the average domestic and I&C p/kWh should be used as the comparitor in determining if charges have reduced by more than 1% on the previous years charge. Specifically AQ's will be shipper and IGT's agreed for the reasons noted in "*nominated AQ*" above.

Industrial and Commercial properties.

Industrial and commercial properties carry higher risk to Transporters, due to uncertainty in future consumption and indeed the length of time they will be in existence. SP Gas believes risk should not be borne by the shipper/supplier or indeed the incoming consumers in the property. Instead IGT's should be permitted to recover the Transco equivalent charges as defined above, and no more, taking the 1% floor calculator into account.

It should be for the IGT to take and mitigate the risk of these projects, possibly through SLC4B charges where the developer would fully fund the installation, the IGT could rebate the capital value of the installation through revenue, as and when the predicted AQ is realised.

- ✓ The commercial risk of these projects is a matter for the IGT and the developers to take, not the shipper and ultimately the consumers. Charges should always be in line with Transco Equivalent and thus promote competition between shipper/suppliers.

Infill Projects

The current SLC 4C provides for infill projects however the designated area does not define "genuine" infill projects i.e. rural or existing villages, the definition of "not within 23m" can apply to most new housing developments and requires to be amended to reflect the intention of this licence condition.

- ✓ It is for the IGT to apply under SLC 4C to apply supplemental charges to recover additional capital involved in taking as to non-gas "rural" areas. It is for Ofgem to consider applications on an individual basis.

Comments on Cost of Capital Consultations

SP Gas's response to this consultation is attached for reference and should be read in conjunction with the undernoted salient point's extracted for clarity:-

1. Comparison to established/mature water companies and newly emerging IGT's cannot be made.

2. Four bankers and Capital market professionals, whose names are noted in the paper referred to above, advised SP Gas would not gain finance as a ring-fenced company without a parent company guarantee.

3. IGT's carry liabilities, which outweigh their cash reserves (£500K in network code alone). If this exposure were to crystallise they would be bankrupt.

4. IGT's have little balance sheet strength, they can only compete in the market by embarking on a capital spend policy and since funding is not available from existing income (like water companies and Transco) they require funding from shareholders or capital markets. Whatever the source IGT's are in a competitive market for finance.

5. CAPM model is appropriate for mature companies with investment, which is liquid and can be bought and sold. IGT's are illiquid and do not have a comparable beta factor, which is required in the CAPM model. Clearly IGT's carry higher risk than mature water companies and Transco as used in Ofgems comparison.

CAPM is not applicable to IGT's. Undernoted is a hypothetical example of WACC assuming CAPM could be applied to IGT's for assistance in determining reasonable rate of return. SP Gas do not believe 7.7% is reasonable or achievable in the capital and equity markets for the reasons outlined in SP Gas's submission on Ofgem Consultation Paper on Independent Gas Transporters Charges and Cost of Capital dated February 2002.: -

Cost of Debt		
Base lending rate	3.75	Current Base interest rates (variable)
Debt Risk Premium	2	%tage over base lending (variable). This is an assumption, based on Ofgems low risk model, since no lender has been identified who would lend SP Gas without a parent company Guarantee. The capital market professionals as advised, in SP Gas's submission to Ofgem, that assuming they could find a lender a minimum DRP would be 3.5%
	5.75	
Cost of Equity		
Base lending rates	3.75	Current base interest rates (variable)
Risk / profit	4.25	WOC consultation paper referred to by Ofgem concludes between 3.5 and 5%. 4.25% is mid ground, however comparison with a mature water company is not applicable in the first instance.
Equity Beta	1.	Ofgem assume IGT's to be the same as Transco. The discussions in SP Gas's submission Feb 02 show this assumption to be wrong. A beta factor is not applicable to SPG but if it were it would be greater than Transco's.
Small Company Premium	0.8	If IGT's were totally ring-fence debt finance would not be gained at all. Therefore it is appropriate to include as a risk factor for equity investors. Should SP Gas in the future gain funding as a ring fenced business it could be argued this should be eliminated.
Gearing	37.5	Gearing is not appropriate since SP Gas cannot gain debt funding without parent company guarantees.
Post tax C of E	8.8	
Taxation adjustment	1.43	
Pre Tax C of E	**12.58**	
WACC	10.02	

Since debt finance cannot be gained by SP Gas gearing is not appropriate, 12.58% would therefore be an absolute minimum defendable rate of return and therefore SP Gas concludes 15% complies with current "reasonable profit" definition under current licence conditions.

The above and the paper submitted to Ofgem on cost of capital provides evidence that Ofgems defined rate of return is not reasonable, achievable in the markets or defendable under SLC4.

As noted above SP Gas believe their current methodology to be compliant with SLC4 and since this methodology results in a price cap to Transco equivalent charges should not have an Ofgem rate of return, with measurement of compliance over short timescales prescribed to it.

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