

LE Group
Templar House
81-87 High Holborn
London WC1V 6NU

Tel: +44 (0)20 7242 9050
LDE DX 487
www.le-group.co.uk

Date

12 February 2003

Our Ref

Your Ref

Direct line: 020 7331 3563

Local fax: 020 7331 3658



Frances Warburton
Head of Gas Distribution Regulation
Regulation and Financial Affairs Division
Ofgem
9 Millbank
London SW1P 3GE.

Dear Frances

The Regulation of Independent Gas Transporter charging – Draft Proposals – December 2002

LE Group welcomes the opportunity to comment on “The Regulation of Independent Gas Transporter charging – Draft Proposals” document and has the following points to make.

We note the analysis that Ofgem has undertaken to support its initial conclusions that: -

- the majority of Independent Gas Transporters (IGTs) are unjustifiably charging more for the transportation of gas than would have been the case if Transco operated the same part of the network;
- this is not in the best interests of customers; and
- hence requires the use of relative price regulation, with Transco’s charges to be used as the relevant comparator.

Ofgem has noted (paragraphs 3.18 and 4.13) the potential limitations of its own analysis of IGTs’ versus Transco’s costs and charges undertaken to date. The effects of these and other limitations could be material. Additionally, without publication of the underlying calculation methodology, it is not possible to comment fully on the appropriateness of the comparisons of charges and costs. Consequently, on the basis of the evidence presented by Ofgem, we are concerned that it may not be possible at this time to reach robust conclusions about whether or not IGTs’ charges are too high in relation to the costs of servicing customers on those networks.

If further analysis shows unambiguously that IGTs’ charges relative to their costs are higher, without good reason, than the equivalent Transco charges, then we would support the use of relative price regulation, at least as an interim solution. However,

if the interim solution is to remain in place for some time, Ofgem should create the possibility of a derogation from relative price regulation for instances where the efficient level of costs of a particular development or connection would imply charges higher than the equivalent Transco average charge comparator. This could be a straightforward mechanism requiring approval by Ofgem in that instance only, following an application by the IGT accompanied by the appropriate evidence. The absence of such a derogation is likely to lead to an ever increasing proportion of the more expensive developments being served only by Transco, as they would be uneconomic for IGTs to serve. This may not be in the interests of customers.

We remain unconvinced that the use of relative price regulation is appropriate in the longer term, though it would clearly be more convenient for suppliers. The costs of connections are by their very nature project specific. Many factors can affect the costs of new build. A comparison of charges is further complicated, amongst other things, by the differences in:

- the period over which IGTs recover their capital costs versus the old and new Transco regulatory depreciation periods;
- the under-valuation of assets at privatisation and the continuing consequent effects on Transco's charges; and
- the effect on Transco's charges of its performance under various incentive schemes.

A more robust solution in the longer term would be: -

- competition in the initial tendering process to construct the network. This should be facilitated by removing perverse incentives to pay disproportionately large payments to developers (see final bullet below) and removing potential cross subsidies between gas transportation and supply by introducing financial ring fencing provisions;
- amendment of charging licence obligations accompanied by the adoption of standard charging methodologies, so that there is more consistency by gas transporters in relation to the split between connection and transportation charges;
- ex post rate of return regulation based on a company's own efficient costs using the Authority's existing Competition Act powers where, for example, there is a complaint for overcharging. This assessment should exclude disproportionately large payments to developers as an allowable cost; and
- an incentive on gas transporters to seek contributions from developers towards the costs of the connection where it is appropriate in the circumstances.

LE Group's own supply business's experience suggests that charges on IGT networks can be unusually high compared with Transco's charges. This experience implies that there may be problems with the current arrangements that may not be in the interests of customers. Consequently, LE Group would welcome any soundly based action by Ofgem to ensure that, where the high level of charges is unjustified, the situation is remedied and, where appropriate, financial penalties are imposed on

IGTs for any past abuse. However, any action should be based on clear and unambiguous evidence.

More detailed comments on Ofgem's draft proposals document are attached to this letter. I hope you will find our comments helpful. If you have any queries, please do not hesitate to call either Tahir Majid on 020 7487 7274 or myself on 020 7331 3563.

Yours sincerely

Denis Linford
Head of Regulation

Attachment

The Regulation of Independent Gas Transporter Charging – Draft Proposals – December 2002

1. Analysis of costs and charges

Before drawing any conclusions, data should be normalised for the effects of: -

- differences in cost efficiency, the most efficient companies should be able to earn higher rates of return compared with their peers for the period of their efficiency outperformance - at the last distribution price control review, electricity distributors at the efficiency frontier were rewarded with an effective X value of zero, whereas other distributors had to reduce their costs in real terms;
- different charging arrangements, i.e. differences in the split between connection and transportation charges and differences in the period and profile of recovery of costs;
- differences in age of sites, especially where new IGT assets are being compared with an average basket of Transco assets, some of which have been fully depreciated and hence make no capital cost contribution to the assessment of charges, or are being compared with assets that retain their privatisation under-valuation in the Transco regulated asset base;
- differences in the average size and Annual Quantities of site;
- asymmetries in the distribution of IGT sites across geographic regions, especially in the light of the material cross-subsidies inherent in Transco's costs between LDZs - Ofgem is not proposing to fully unwind these for some years;
- payments to developers - disproportionately large payments should be removed from the allowable costs;
- the link between cost and quality. In general, new networks can be expected to deliver superior quality of supply performance. In any event, an assessment of costs has to be done within the context of the cost-quality linkage;
- the effect on Transco's charges of its performance under various incentive schemes; and
- number of customers served, as in electricity distribution where the size of the customer base is a significant factor in determining the efficient level of costs, this appears to be supported by Ofgem's analysis.

Additionally, a much larger sample size should be used in the analysis to make any comparisons meaningful, because costs between individual connections of a similar size can vary greatly.

2. Enforcement action

We have concerns about the robustness of the analysis that appears to show similar IGT and Transco costs compared with IGT charges up to twice Transco's charges.

However, it is surprising that Ofgem has sufficient confidence in the results of its own analysis to propose changes to the way that it regulates IGTs while this confidence does not lead Ofgem to take the more obvious course of action, that is to undertake enforcement action under the Competition Act against IGT abuse of dominance.

3. Cost of capital

We note with interest that Ofgem (definition of reasonable profit for Condition 4 transportation charges – 29 November 2002) proposes to enforce a reasonable profit test based on a real pre-tax cost of capital below 7.7% for Condition 4 transportation charges from 1st April 2003. Reasonable profit would be measured using an NPV test and/or test of average return in the previous three years. IGTs in breach of this test might be subject to financial penalties pursuant to powers deriving from the Utilities Act or Competition Act. This method of regulation is closely aligned to our preferred longer term approach outlined earlier. However, as noted in our response dated 12 April to Ofgem’s “Independent Gas Transporter charges and Cost of Capital” document, we remain concerned about the appropriateness of the use of 7.7% as the cost of capital.

4. Option A, excluding competitive franchising plus option E

Ofgem dismisses “Option A excluding competitive franchising plus option E” with very little explanation. For example, it is not clear why Ofgem does not propose to amend the existing licence conditions, if, as stated elsewhere in Ofgem’s document, their wording provides inappropriate incentives and is unclear. As noted earlier, though we have concerns about the Ofgem analysis, it is not clear why Ofgem cannot use its existing powers under the Competition Act. We would welcome further explanation of Ofgem’s rationale in this area.

5. Financial ring fencing

It is important that customers are afforded the protection of financial ring fencing. This should ensure that customers are not affected by

- the financial instability of an IGT’s parent, e.g. Enron and Azurix’s regulated water company;
- potential siphoning off of resources in the short term to the long term detriment of customers; or
- cross subsidies to or from other parts of the business including affiliated supply businesses.

There should be no reason why an established small company cannot maintain an investment grade credit rating, though there may be issues with the cost of setting up and maintaining that rating relative to the size of the IGT’s cost base.

Getting and maintaining the appropriate credit rating may be somewhat problematic for a company in the start up phase. However, an IGT start-up could still use legally enforceable guarantees from its parent company to achieve the required rating. This

arrangement is clearly similar to Ofgem's proposal for a 'keep well' agreement. The key difference is that the credit agency and not Ofgem would act as the body prescribing the conditions necessary to qualify and then maintain the investment grade credit rating. It would be preferable for the credit agencies rather than Ofgem to carry out this role in light of their expertise in this area.

Incorporation of the SLCs contained in Section C of the GT licence will be an appropriate form of protection for the customers of IGTs.

6. Ofgem's Proposed Approach to IGT Regulation

Though we have noted our concerns about use of relative price regulation, our specific comments on its potential application are given below.

We agree that the most appropriate Transco charge comparator for IGT charges would be the Transco charge for transporting gas through the new gas system extension (measured as the difference between the Transco CSEP charge and the single supply point charge).

Relative price regulation should be applied to charges at site level to minimise regulatory administration. There is little reason for applying the caps at a property level as using the average of all properties on the site allows IGTs flexibility in structuring charges across the site.

There is no basis for setting initial IGT charges below the Transco equivalent charges based on the evidence presented in the consultation document.

A further review of Transco's LDZ charging methodology is required to ensure that the reference price is more cost reflective. However, the outcome of that review should not delay any Ofgem course of action, nor should the timetable of the two reviews be linked. A further review of Transco's LDZ charging methodology is required in its own right.

Though the existing Transco CSEP charge may be cross reflective, its application to IGT connections and not Transco connections has the effect of significantly tilting the market in Transco's favour.

Derogation of relative price controls for rural sites, non-domestic infill sites and where the efficient level of costs would imply a higher charge than the Transco average reference charge, accompanied by the application of annualised connection charges in these specific cases, will provide customers with maximum flexibility.

Having annualised connection charges would be appropriate for those customers who wish to spread their connection payments over a period of time as opposed to paying them up front. However, either option should be clearly identified in the IGT statement for transparency purposes.

We recognise that there is currently no uniform approach adopted by IGTs in their use or estimation of AQs. This should be rectified in order to simplify and standardise the charging methodologies. This will in turn help comparative analysis and invoice validation. Additionally, the current perverse incentive on IGTs to artificially inflate the AQs of sites to give an appearance of Transco comparable charging should be tackled.

Again, we would agree that metering and meter reading charges should be unbundled and clearly excluded from Transportation charges to facilitate validation and comparison with other IGT charges. Governance for such arrangements would need to be put in place to ensure proper validation of IGT charges ideally through the use of standardised invoicing by IGTs.

The simplest approach for legacy sites would be to ring-fence the costs and charges of the relatively small number of existing sites. The application of a reasonable profit test combined with the rigorous use of enforcement action should be used to prevent abuse of dominance.

LE Group, 12/02/03