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# The Regulation of Independent Gas Transporter Charging

## *A Response by British Gas Trading*

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## 1. INTRODUCTION

British Gas Trading (British Gas) welcomes the opportunity to respond to this Ofgem consultation, which forms an important part of their ongoing review of Independent Gas Transporter (IGT) charging arrangements. We understand that this draft proposals paper has been significantly informed by the responses to the May consultation paper on IGT charging and costs.

We agree with Ofgem that the existing structure has deficiencies which need to be addressed and believe that Ofgem's proposal to introduce relative price control, based on Transco-equivalent charges, to be an appropriate and fair approach to future IGT charging. British Gas generally supports this contribution to the holistic review of issues relating to IGT charging.

This response to the draft proposals document is from British Gas as a user of IGT networks.

## 2. EXECUTIVE SUMMARY

- British Gas believes that competition for the construction and the ongoing operation of gas networks can provide an important contribution to the growth of the gas supply market and has the potential to provide real benefits to consumers.
- We fully support any development that increases the effectiveness and competitiveness of the market in gas network expansion and share Ofgem's aim to establish a more equitable outcome for all interested parties.
- We have previously outlined our concerns about some aspects of the way this market has developed and in particular the considerable flexibility that IGTs have in designing charging methodologies, which may be detrimental to effective competition.
- We believe that this flexibility has had the potential to create the wrong market signals and of particular concern is that it has led to the recovery of allowances given against capital costs (connections charges) via the transportation charge. This effectively allows the connections market to be cross subsidised from transportation charging revenues.
- In addition we believe that in some cases, IGTs may be adopting higher annual quantities (AQs) in the derivation of transportation charges and the resulting potential for increased future revenue offers the opportunity for reducing the contributions from developers in an inappropriate way.
- We believe that Ofgem's proposals to develop a system of relative price control should provide a straightforward and transparent approach for IGT charging and have the potential to resolve many of our concerns. We believe that, if properly implemented, relative price control should facilitate further effective competition on those networks both between shippers and suppliers and provide significant benefits to consumers.

- We do however have concerns which we believe need to be addressed before the adoption of relative price control. These are: achieving the required level of confidence in the benchmark against which the IGTs are to be compared; achieving a review process which balances the interests of users and investors; and reaching consensus on how legacy sites are to be handled. We discuss these issues further in section 3.
- With regard to financial ring fencing, we are unclear as to the additional regulatory burden Ofgem's proposals would bring. It would be helpful if Ofgem were to quantify the additional benefits especially those relating to perceived short comings in the current undertakings.

### 3. GENERAL COMMENTS

The following section outlines our comments on the document and for ease of reference the relevant paragraphs have been included in square brackets.

[PARA 2.17] - There is little evidence that the varying approaches to charging methods has resulted in the innovation and differentiation of products, certainly not at the transportation end. The fact that charging approaches do vary, does not in itself result in shippers/suppliers avoiding customers on some sites - it is the overall transportation cost that is the differentiator.

[PARA 2.18] - we agree there are not enough incentives for IGTs to operate efficiently.

[PARA 2.21] - The end user customer relationship is with the supplier and not the IGT. Given that transportation charges make up a significant proportion of a customer's bill, the customer will be more concerned with price than service where the balance between these appears to get out of line as is the case on some IGT networks.

[PARA 2.22] – We believe that builders and developers will not be discouraged from making gas connections since their costs will be recovered via house prices.

[PARA 3.20] – We find the statement that payments to developers have little correlation to higher transportation charges, odd, given that payments must be recovered. This appears to go against our considerable experience in this market. Similarly, we are surprised that there is little correlation between age of site and the level of charge incurred.

[PARA 6.24] – We understand that Ofgem are currently considering separate price controls for Transco's LDZs. Were this to happen, we are concerned that relative price control may not remain as the appropriate approach to regulate IGT charging arrangements. Currently, many overhead costs are averaged out between LDZs and therefore the discrepancy between Transco equivalent costs are marginal. Separate price controls will expose the different cost structures of each LDZ and identify those which are relatively efficient and inefficient respectively. We believe that the cost to operate may vary significantly. These costs will feed through into the benchmark costs to which IGTs will be pegged. As a result, we see there is a real risk that IGTs will compete in the less efficient LDZs where the potential returns may be high, and decline from competing in efficient LDZs where returns may be low. We welcome Ofgem's thoughts on how they anticipate relative price control developing in the face of LDZs under separate price controls.

## **4. RESPONSE TO ISSUES RAISED BY OFGEM**

### **1. Is Transco the most appropriate comparator against which to set a relative price control for IGTs?**

We believe that Transco has the potential to be an appropriate comparator for benchmarking IGTs. However, we are concerned that the current level of Transco charges reflects a different history from that of IGTs and that the appropriateness will be largely dependent on the selection and quality of data that is used. We consider that it will be essential to identify correctly Transco's costs and outputs that are directly comparable to those incurred by IGTs.

We do not yet consider that there exists the transparency or refinement in Transco's accounts to provide this reassurance and would like to see further work in this area.

Also we have concerns that inconsistencies in cost allocation practices between Transco (which is governed by RAGs) and IGTs (which are not) may lead to limitations in setting the benchmark. We believe that once benchmarks have been established for each LDZ an ongoing review process is adopted. To identify shortcomings, this review will need be at site level and complemented by a mechanism to correct shortcomings. Moreover, the active co-operation of all parties involved will be needed. We also believe that there is merit in reviewing the potential benefits of employing overseas comparators to complement the work carried out based on Transco data. Although we acknowledge the difficulties arising from different accounting standards, useful overseas comparisons have been undertaken in the water industry.

### **2. Should IGT charges be compared to Transco's incremental equivalent charges from CSEP to SSP?**

Theoretically we agree that Transco's incremental equivalent charges from CSEP to SSP would provide an appropriate benchmark. However, we do have two concerns that we believe need to be considered before any conclusions are finalised. Firstly, we understand that Transco's incremental equivalent charges from CSEP to SSP are calculated based on Transco "all the way" charges minus Transco's charge to CSEP. These charges will have been constructed to achieve a number of outcomes, one of which may be cost reflectivity. As such, there is the likelihood that there will be a discrepancy between these costs and those resulting from the direct activities of an IGT.

A further concern is that Transco's incremental equivalent charges from CSEP to SSP are based on average costs incurred within an LDZ and this likewise may lead to apparent discrepancies between IGT and Transco charges that are unjustified.

As suggested in our response to the first issue, we believe that the initial Transco's incremental equivalent charges from CSEP to SSP will need to be reviewed and adapted if these real concerns are to be addressed.

### **3. Whether application of the relative price control should focus on site level charges or property level charges?**

We believe that it is important for Ofgem to promote methodologies that are straightforward to administer and provide transparent comparisons. We do not see

significant benefit in applying the relative price control at the property level and, given that a weighted average of the AQ of all the properties has now been successfully employed under Condition 4C charging arrangements, consider that it is appropriate to extend this principle to all sites. However, we understand that this will give IGTs discretion in structuring charges across properties and would like to see some checks and balances to ensure individual properties are not unfairly treated.

#### **4. The level of the relative price control, equivalent to Transco or below Transco?**

We believe that the market will ultimately determine the level of the relative price control but given that Ofgem's preliminary analysis indicates that the costs incurred by Transco and IGTs are broadly similar, we see no reason why the price control should not initially be set at parity with Transco's incremental equivalent charges from CSEP to SSP. We also agree that if the charges are set below Transco's there may be incentives to recover a greater proportion from the connections which may result in a detrimental effect on the connections market.

#### **5. The path of charges over the relative price control, whether charges should track Transco's charges (possibly with fixed floor prices) or follow their own path between reviews?**

We understand that one of the contributing factors that has led to the divergence in charges between IGTs and Transco is that whilst Transco charges have tended to reduce, as they are subjected to review through the regulatory process, IGTs are fixed for a defined period. We would not wish to see this perpetuated.

However, we also recognise the benefit to IGTs that the fixing of charges, for an agreed period, brings. We appreciate that in order to encourage investment in networks, which are long life investments, providing adequate security of expected returns is necessary for IGTs to properly finance such developments.

Out of the three options outlined by Ofgem, namely to continually follow Transco-equivalent charges; stay constant in real terms (follow RPI) until next review; or fall in real terms until the next review, we favour the first. Whilst we agree that this approach will increase the uncertainty of IGT's forecast revenues, we believe that this detriment is more than offset by the delivery of benefits to the customer resulting from efficiency savings achieved by Transco. Further, we believe that shippers and suppliers would benefit from the clarity such an approach would bring.

To ensure against windfall gains and losses caused by unexpected changes in Transco's charges, we would expect to see a ceiling and floor applied to any given site. This would help to mitigate against any resulting uncertainty in relation to revenue and avoid the discouragement of investment.

#### **6. The scope and timing of the review of the relative price control, should reviews be based on set periods, rolling reviews or phased reviews and the length of time between reviews?**

It is our opinion that reviews should be based on set periods. Due to the nature of the review and the effect it will have on the IGT's, it may be prudent to recommend initial

review periods of 12 to 18 months, with a view to extending the period between reviews at a later stage, potentially following the existing Transco model.

### **7. The basis of the review, including whether performance measures are appropriate?**

In principle, we agree that performance measures can play an important role in adjusting charges and that good performance should be rewarded and poor performance penalised. However, we are unconvinced, that in the case of IGTs, the costs of setting up such a scheme would be justified by the benefits achieved. We currently tend not to experience major operational problems on IGTs and consider that these are adequately dealt with under provisions in the current Gas Transportation Licence. The primary concerns we have are related to charging levels, customer transfer processes and the provisioning and maintenance of PPMS. We anticipate that many of these concerns will be addressed by this review.

### **8. Whether a review of Transco's current structure of charges should be undertaken, including whether these charges provide the appropriate price signals to IGTs and consumers?**

We believe that a system of relative price regulation, based on Transco's incremental equivalent charges from CSEP to SSP, will need to be supported by a thorough review of Transco's current structure of charges. We understand that the current structure has evolved to satisfy regulatory requirements which may not be wholly aligned with the requirements of relative price regulation. We believe that it is essential to set the benchmark at a level that allows IGTs to participate in the market without earning excessive returns.

### **9. Whether any such review of Transco's charging structure should occur before or after the introduction of relative price regulation and whether adjustments should be made to charges levied in the interim?**

Given that some IGTs manage to compete in the market at Transco current charging levels we see no reason why the review of Transco's structure of charges cannot be concluded following the introduction of relative price regulation. However, we recommend that provision is given for the appropriate adjustments to be made to charges set prior to the conclusion of this review.

### **10. Whether the relative price control should apply to rural infill and non-domestic sites?**

With regard to rural infill sites we have previously stated that we see the rural extension as being primarily a socio-economic issue and as such warrants special attention. We believe that relative price regulation would have a negative impact on this market sector and therefore Ofgem should, in clearly defined circumstances, consider exempting these from this control. We do have concerns however, that rural network and infill sites have decreased fundamentally due to economic factors and trying to stimulate additional connections via IGT regulation may prove disproportionately expensive for all customers to bear.

With regard to non-domestic sites, we believe that consumers should have the freedom to enter into agreements that best suit their commercial circumstances, including (possibly) reducing upfront costs via a supplementary transportation charge. We would not recommend that this flexibility be constrained by the imposition of relative price regulation.

**11. Whether annualised connection charges would be appropriate for non-domestic sites and infill sites as necessary?**

See above comments.

**12. The most appropriate measure or approach for AQs used in determining transportation charges?**

We would recommend that a standardised approach to AQ's needs to be developed which provides a better relationship between connected load and AQ's used for the determination of transportation charging.

Further, we suggest that there is a need for transparency of the Design AQ values currently used by all IGT's and Transco and that the industry works towards the development of a standard Design AQ matrix, to be used on all new sites developed by IGT's. This would prevent the application of inflated values.

**13. Whether metering and meter reading charges should be unbundled and clearly excluded from transportation charges, especially if Transco is used as a comparator?**

We believe that it is appropriate to exclude metering and meter reading from IGT transportation charges to enable comparison with Transco's charges.

**14. Whether clear governance arrangements need to be put in place to ensure easy validation of IGT charges, including standardised invoicing by IGTs?**

We agree with Ofgem that the existing range and form of IGT invoicing methods does not provide for straightforward validation and standardisation in this area. We would welcome a review of the costs of other transactions (e.g. customer transfers) for customers connected to IGT networks as these are significantly higher than those for similar transactions for Transco connected customers. IGTs currently have a range of processes, formats and standards and they should be encouraged to develop common ones (where appropriate).

**15. Whether incentives for IGTs to focus on low cost sites is outweighed by the overall advantages of relative price regulation?**

With regard to the higher cost sites, we believe that it is difficult to predetermine how the market will react once relative price regulation has been implemented. Further, we are uncertain as to the differential and distribution of the costs of development sites and therefore have difficulty in accurately quantifying the problem. We suggest that overall advantages of relative price regulation will outweigh the potential disadvantages arising from some higher cost sites not being contested. However, we would urge Ofgem to



monitor this situation closely and to ensure that sufficient flexibility exists to address this concern.

## **16. The approach to take on legacy sites and harmonization between existing and future IGT charges?**

With regard to sites that predate the new arrangements, from an IGT user's perspective, we suggest that ideally they should all be migrated to the new arrangements.

We note that Condition 4C sites post 7 December 2001 Interim Arrangements are closely aligned with the new charging arrangements and therefore see little reason why these cannot be transferred with relative ease.

With regard to Condition 4C sites that predate these arrangements, we appreciate that the transfer process may be more complex. Likewise with Condition 4A we accept that these will not be so easy to transfer but consider that, following the recent work on clarifying the position on reasonable profit, anticipate that the differential between the Transco benchmark and revised charging arrangements will be greatly reduced.

From the three options outlined by Ofgem, we favour the provision of a timetable for phasing in the new arrangements for existing sites and, if an IGT chooses not to participate in the proposed arrangements, these sites would be ring-fenced under the existing arrangements.

## **17. With regards to financial ring fencing, whether:**

**financial ring-fencing provisions should apply to IGTs ;**

**the existing financial ring-fencing provisions set out in SLCs 43 to 47 would be appropriate given the circumstances of IGTs;**

**SLC 46 should be modified as suggested in paragraph 8.16**

**the suggestions for keep well arrangements in paragraph 8.17 are appropriate; and**

**there should be any other changes to financial ring-fencing provisions for IGTs**

We understand that, as financial ring-fencing has not been subjected to previous consultation, discussions here should be considered as an initial consultation and will inform draft proposals which are to be published at a later date.

We agree that financial ring-fencing provisions may provide safeguards for the financial stability of individual companies that form part of a larger group and that this may provide consumers with protection from insolvency. This was recently demonstrated in the Enron collapse where customers of Wessex Water were protected from disruption and uncertainty. This enhanced security also allows financial markets to be accessed at reasonable rates.

However, we believe that the extent to which financial ring-fencing is employed must be proportionate to the companies under consideration and in part must reflect the potential for failure and consequence of failure.

We understand that, in the case of IGTs, financial ring-fencing was mooted as part of the cost of capital (CoC) consultation where Ofgem considered that, to qualify for a small company premium, a higher degree of financial ring-fencing would be required. As the relevance of the CoC (and reasonable profit) debate has diminished, we are uncertain of the benefits further ring-fencing will bring to this issue.

With regard to whether SLC 43 – 47 are appropriate, we would like to see further details on the impact these conditions are likely to have on the regulatory burden imposed on IGTs. Our initial thoughts are that they do not appear to be over burdensome but reserve judgment until the further details are included in the draft proposals.

If it is concluded that the benefits outweigh the costs of imposing SLC 43 – 47, we would recommend that, for regulatory consistency, both modifications are adopted.