BRITISH GAS CONNECTIONS LIMITED

RESPONSE TO OFGEM'S CONSULTATION PAPER:

REVIEW OF TRANSCO'S STRUCTURE OF DISTRIBUTION CHARGES – MAY 2004

British Gas Connections is pleased to provide its views to Ofgem on the above consultation paper.

Following the application of new gas transporter licence conditions in December 2004, as predicted and discussed with Ofgem at the time the outcome to the review of Transco's charging structure could have a significant and potentially adverse impact on the financial well-being of non-Transco gas transporters. This has broadly been accommodated by a disapplication function in the relevant licence conditions. That said British Gas Connections continue to hold the view that Transco's charges to CSEPs are excessive, lack transparency and do not reflect costs. In addition the derivation of such charges and the functions involved are unduly complex and have remained largely unchallenged by Ofgem and the industry.

Overall, British Gas Connections is disappointed with the very brief discussion of IGT issues, particularly in relation to RPC charging that merited only a very brief and perfunctory paragraph in section "Issues for Consideration". During the discussions IGT companies held with Ofgem on RPC development issues Ofgem acknowledged the importance to IGTs of having in place a more transparent Transco charging methodology. Whilst some specific related issues are discussed in earlier parts of the consultation it would have been helpful and more meaningful to have had some discussion and explanation on how Transco's charges can serve to limit an IGTs' ability to generate transportation revenue and how, without adequate transparency, Transco's charges could be manipulated to distort competition in new connections.

Our specific response to the list of issues is as follows:

Issue 1: Whether Transco's distribution use of system charges should be made more cost-reflective and, if so, what sort of changes would be appropriate.

In principle, Transco's charges should be made more cost-reflective with a move away from the highly postalised method currently in place. However, any major changes would have a potentially negative overall impact if Transco, shippers and suppliers were, as a consequence, required to invest heavily in new customer billing systems. Notwithstanding this, a proper cost-benefit analysis should be conducted to consider the benefits of possible structural changes, measured over the medium to long term.

Our expectation is that structural changes will be kept to a minimum on one level – as part of the discussions into possible sales of some of Transco's Distribution Networks (DNs) shippers and other industry players have been vociferous in opposing any deviation in the transportation charging methodologies between DNs. This does not necessarily mean that they would be opposed to some changes to the current structure (so long as the resultant structure is identical for all 8 DNs).

However, if the above constraint is to be assumed, this does not mean that levels of charges should not vary between DNs and this should perhaps be one of the main areas of focus.

We believe that inertia in shipper and supplier companies' ability to cope with more complicated charging structures will be a key limiting factor. However, the same companies are being faced with an increasing burden of complexity in managing RPC charges on IGT networks – RPC charges are essentially supply point specific.
We would be looking for Ofgem to require Transco to completely unbundle its costs to facilitate the development of a more transparent and cost-reflective charging methodology or, at least, to allow Ofgem to measure the impact on different customer groups of retaining the current methodology. In particular, a clearer picture of the actual costs of transporting gas to IGT CSEPs would be helpful.

It is not exactly clear why interruptible customers should be completely exempt from capacity charges. It would be interesting to consider the value of each such customer to Transco, by way of avoided reinforcement costs, and how this compares with transportation revenue loss from such customers over some defined time period, i.e. some form of interruptible economic test should be used. Any adverse or beneficial impact on interruptible customers could be phased-in over time.

We would propose that the review fully identifies and investigates the implications of some of the key technical issues associated with the current methodology. For example, does the method of scaling charges severely limit cost-reflectivity and price signals and does it lead to a degree of cross-subsidisation between different customer/ consumer groups? Also, are composite charging functions properly structured such that the determination of intersection points, such as those at the 73,200 kWh AQ points for LDZ capacity and commodity charges, does not lead to a distortion in price signals?

Issue 2: Whether the capacity/ commodity split should be changed.

It would be helpful to measure this against a set of criteria not limited to the impact on transportation charges for different customer groups. Having said that the treatment of interruptible customers would have to be very carefully considered if the capacity share were to increase substantially.

Additional criteria ought to include:

- the impact on the year to year stability of charges
- the likely seasonal impact on charges to shippers
- the frequency with which Transco might revise its charges
- the possible impact on RbD.

Issue 3: Whether a more shallow distribution connection charging boundary should be adopted and on-going distribution charges increased to recover the additional costs of reinforcement.

The issue should not be one of whether a more shallow charging boundary is adopted but one that attempts to define appropriate and transparent criteria for assessing where the charging boundary ought to be. Some circumstances surrounding a proposed new connection might, in the context of the criteria, suggest a relatively shallow connection boundary whilst other circumstances might suggest otherwise. Whilst we recognise the potential benefits of simplicity and transparency that may arise from the applications of a shallow connection approach we believe a significant component of the criteria ought to be concern for the protection of consumers, whether existing or potentially new. This also needs to be weighed with Transco's obligation to economically develop its pipeline system. Costs, benefits and risks need to be identified, assessed and allocated among Transco, existing and potentially new consumers. Risks, such as from stranded assets, need to be mitigated where possible through contractual arrangements with newly connecting parties so that they are not automatically passed through to existing and, possibly, future new consumers.

It is also of great importance that attention is paid to the on-going development of competition in new connections and that parties competing with Transco in the new connections market are not placed at any disadvantage from the application of an unduly complex charging boundary policy.

Issue 4: Whether Transco's Economic Test should be reviewed, for example to consider the potential asymmetry of the test and potential asymmetry of sharing of efficiency savings when upsizing occurs.

In our view the principles of Transco's Economic Test should be reviewed. We believe full details of the economic test should be published and available to connecting parties in order to ensure that a consistent approach is applied by LDZs and connecting parties. We see no reason why this same test should not be applied to all connection types irrespective of whether reinforcement is required or not, and that Transco should be able to apply revenue generated to sponsor efficient network growth by way of applying allowances to offset connection costs to its networks.

Our concern with the asymmetrical aspect of the current test is that it could provide Transco with a competitive advantage in the new connections market, for example expected gains from additional transportation revenue could be used to subsidise other aspects of new connection work.

Issue 5: Whether the impact of RPC regulation of IGTs should be considered and the CSEP charging function and administrative charge reviewed.

The impact of any changes to the Transco charging structure on IGTs must be considered as part of the review. It is essential that IGTs are faced with fair and transparent costs when competing against Transco in the new connections market. Also, the revenue earning ability of IGTs needs to be considered so that they can continue to earn a reasonable profit and not have their investments put at risk through the emergence of any volatile Transco charging regime.

The current postalised charging methodology used by Transco inevitably disguises the true costs of transporting gas to specific localities and consumers. It is therefore most probable that the structure of the methodology, including the collation of cost data to correspond with the structure, results in non cost-reflective charges to CSEPs. Because the costs associated with low pressure offtake tiers are relatively high there is a real possibility that imperfections and the averaging effects of Transco's current charging methodology result in charges to CSEPs that are too high due to incorrect assumptions about system usage by consumers connected to IGT pipeline systems: they are assumed to use more of Transco's pipelines than they actually do.

The CSEP Administration charge has always been viewed by us as being an unfair surcharge on shippers who ship gas on IGT pipeline systems, i.e. it represented inefficient systems and process development on the part of Transco. The charge is excluded from the RPC mechanism so does not directly affect an IGT's revenue earning ability but it does still place a surcharge on shippers, some of whom pass on such surcharges to consumers. As such, it can be viewed as discriminatory and should therefore be removed.

Issue 6: What are the implications for this review, if any, of the separation of Transco's distribution price control and the potential sale of DN's.

The charging review will to some extent, depending upon its scope and objectives, create uncertainty and will therefore complicate the investment decisions of potential purchasers as the outcome could impact on the cash-flows arising from transportation revenue and on the size of sums to be invested in pipeline extensions and reinforcement.

It might therefore be equally valid to ask what are the implications of the DN sales on this review of Transco's structure of distribution charges. Our expectation is that a complete, thorough and unconstrained review will be conducted by Ofgem even if the end result has to be tempered, in a clear and transparent manner, by considerations such as DN sales and to what extent the outcomes of such a review shall be applied to DN purchasers as well as Transco.

I trust that the above comments will be of some help.

Yours sincerely,

Graham Jack
Gas Transportation Manager
14 June 2004