British Gas

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Dear Frances,

Re: Ofgem's consultation on the review of Transco's structure of distribution charges.

British Gas welcomes the opportunity to respond to Ofgem's consultation on the review of Transco's structure of distribution charges.

Our response is structured in two parts. Firstly, we provide comments on the six issues raised in the consultation document with particular focus on cost reflectivity and the capacity / commodity split. Secondly, we offer further comments on points of detail arising from statements contained within the body of the consultation document. We are happy for our response to be placed on the Ofgem website.

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?

Whilst we recognise the rationale behind Ofgem's decision to revisit the current structure of Transco's distribution charges, and, whilst we also accept the principle of cost reflective charging, we are strongly opposed to any change in this area in the short-term. Primarily, we are unconvinced that the benefits to the industry arising from the proposed amendments will be greater than the costs of implementation. In addition we believe that there are significant practical problems associated with the application of more cost reflective charges and, finally, we have concerns regarding the negative impact these proposals may have on Ofgem's Social Action Plan. We expand upon these concerns below.

We are not convinced that reform of Transco's distribution charging will lead to any material increase in efficiency and believe that the proposed amendments would need much closer consideration and justification, balancing the benefits of clearer charging with the implications for the parties affected, prior to Ofgem advancing these proposals further.

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We believe that it is misguided to suggest that, for the generality of new connectees, decisions on location and connections to pressure tiers will be critically influenced by pricing signals coming from distribution charging methodology. In all probability new customers will have no real choice over the connecting route. Even if it could be demonstrated that more cost reflective pricing signals positively influenced the efficiency of new connectees' decisions, we believe that Ofgem's proposals are effectively discriminatory since existing customers are unable to respond to such pricing signals, because their investment decisions have already been made and because the nature of their usage is fixed.

Apart from the discrimination and limited benefit issues, we understand that when this issue was last considered in March 2000, significant problems were raised regarding the practical issues of achieving greater cost reflectivity and also with the costs involved in addressing these issues. For example we recall that there was a significant lack of reliable data available to measure supply point, or customer class, use of capacity and without an effective monitoring system (e.g. half hourly data logging) it was believed that it was impossible to identify usage and charge appropriately. We also recall that there were concerns regarding the identification of the true cost drivers associated with the operation and maintenance of mains pipe work. For example, the significant costs of emergency services are perhaps more related to the continuous flow of gas through the system rather than peak flow. We believe that these issues have yet to be resolved and therefore remain relevant for this review.

In conclusion, we understand and would support the general aim of cost reflective charging, provided that real benefits are produced and implementation can be realistically achieved without excessive cost. However, in our view the case for changing the current structure of distribution charges has yet to be made. The benefits appear to be minimal, whereas the cost implications for the industry could be significant. These costs are associated with the compliance and administration of operating in a more complex charging regime, resulting from multiple load factors, changes to customer consumption estimation processes and implementation difficulties.

Further work on these aspects and the other related charging issues would be necessary before we could support an alternative to the present arrangements. Ofgem has advanced no cost benefit analysis to support any of its proposals; this must be done before we would have any confidence that the changes proposed will lead to real benefits for all customers, not just a few at the expense of others.

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

A high capacity / low commodity split favours high consumption / high load factor customers, conversely those customers with low consumption / low load factors i.e. the majority of domestic customers would be disadvantaged.

Most Suppliers only charge through commodity rates, accordingly, we have significant reservations about the potential impact that making charges more cost reflective via changing the capacity / commodity split will have on customers with low consumption. Ofgem's work towards its Social Action Plan, which was launched in March 2000, has sought to reduce the total number of households in fuel poverty. There have been a number of measures introduced across the industry which have contributed to this success, a situation which has been further helped by falling fuel prices. However, in its recent review of progress towards the goals set out in the plan, Ofgem has identified that continued progress towards reducing the number of households in fuel poverty will be hampered by the impact of escalating fuel costs, much of which seems likely to be passed on to customers. Against this background, it would seem inappropriate to add further to this burden by restructuring gas transportation charges, a process that will have an inflationary impact upon small gas users.

We believe that if Ofgem changes the current capacity / commodity split there will be further negative and unwelcome impact upon customers in terms of increasing debt levels which could ultimately flow through to increasing levels of disconnections. Indeed, we believe that a number of key indicators as set out under Ofgem's Social Action Plan could see a negative downturn.

There are other examples where the social agenda has constrained other primary objectives in monopoly regulation. For example, the Government decided to limit water competition to a small number of non domestic customers primarily because of the rural cross subsidy arising from postalised charging. In its conclusion the Government stated the following:

> *"There are also cross subsidies within household tariffs which competition could unwind. Prices are averaged across undertakers' areas, for example, so that people who live where water is expensive to treat and transport, which includes many rural communities, pay the same tariff as those in areas where costs are lower. Increasing competition for households, while at the same time seeking to ensure that the Government's public health, social and environmental objectives continue to be met, would require a complex and costly regulatory regime, which would still leave substantial uncertainties, particularly about the effects on individual customers' bills…. the drawbacks of increasing competition for household customers are likely to outweigh the potential benefits."* [1]

We also have concerns regarding the potential for increased price volatility that changes to the capacity / commodity split may have. Domestic customers prefer to pay a unit rate according to the volume consumed whereas Suppliers pay transportation costs based on the capacity / commodity split and accordingly, the greater proportion of fixed costs i.e. capacity charge, the greater the potential for a mismatch. This mismatch has the potential to impact negatively on customers, for example, in a mild winter (as has become increasingly common) the Suppliers will under-recover costs of supply against forecast, which would inevitably lead to increasing variability in end user prices. This effect will be particularly pronounced in customers with low usage and may lead to the reintroduction of standing charges on a wide scale basis.

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[1] Defra's report on Extending Opportunities for Competition in the Water Industry in England and Wales July 2002

In conclusion it is our view that the current 50-50 split represents a reasonable balance between cost reflectivity and Ofgem's wider objectives. We would caution against any move to increase the capacity weighting of Transco's distribution charge as this could have a serious impact on this balance.

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

We find the suggestion to move to a more shallow distribution connection charging boundary to be ironic when the main thrust of this document appears to be designed to increase cost reflectivity. We would caution against the adoption of a super shallow policy since this discriminates against existing customers, who effectively cross-subsidise new customers. We believe that this cross subsidy will be exacerbated once any DNs become independent and we suggest that Ofgem considers spreading these charges nationally via an adjustment between DNs. We believe that Ofgem should adopt a consistent connection charging boundary with the DNOs.

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

We believe there is no benefit in maintaining the asymmetry where some connectees pay in excess of the required contribution and we therefore support making the charging symmetrical.

Issue 5: Whether the impact of Relative Price Control (RPC) regulation of IGTs should be considered;

We have significant concerns regarding the escalation in complexity for Suppliers that may result in moving to more cost reflective charging. Currently RPC is aligned to Transco's overall distribution charges and is relatively easy to administer; however under separate price controls this is going to become more complex as each IGT is going to have a different RPC for each DN. Even though distribution charges were originally supposed to have a glide path to limit the impact of divergence, we believe that divergence is going to occur sooner than anticipated and that this is going to be exacerbated by the anticipated swings caused by K, the correction factor. As the number of transporters is likely to increase, it is important to consider the impact on IGTs and Suppliers the differing regimes may have and how this may impact upon customers. This is particularly relevant for IGTs if they have to maintain parity in delivered charges to consumers. For example, not only can it be expected that a greater number of tariffs will result, but also the frequency of change is likely to increase unless all participants are restricted to price change windows. We do however, acknowledge that a move away from the current 50 – 50 split may mitigate some of this increased volatility. We refer you to our previous responses on DN disposals and PC 80.

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 Transco's Distribution Networks (DNs).

We believe that it is sensible to wait until the sale process has been concluded and any new owner is given the opportunity to take an active and constructive part in the debate of the future structure of charges.

If the capacity / commodity split were to be changed to say 70-30 across the UK, there would be a risk of advantaging or disadvantaging DNs depending on the physical structure of their network. This may become particularly acute if the methodology continues to use pressure tiers, whereas the retention of 50-50 split may be expected to mitigate this risk.

The further point under this issue relates to the separation of price controls and hence regional pricing. In our response to PC80 we questioned the assumption that regional pricing is appropriate especially in the light of fuel poverty and social agenda objectives. As with Issue 5, we refer you to our previous responses on DN disposals and PC 80.

Points of detail

We now offer further comments on a number of points of detail which we have referenced using the consultation document paragraph numbering.

1.13 Ofgem notes that the sale of Transco's DN businesses and the reform of the exit and other interruptions arrangements could have implications for this review. We believe that any reform of these arrangements would impact upon this review and therefore believe that the sale process should be concluded before further decisions are made on this review.

2.11 We believe that Ofgem's will have no option but to extend the present licence obligation on Transco to operate the NTS in an efficient, economic and coordinated manner to the DNs.

3.15 Regarding the fourth bullet point, it would be helpful for Ofgem to provide details on how the cost of laying pipes is to be apportioned between connection and reinforcement.

3.28 We are happy to reserve our comments on connection charges but ask that when Ofgem consults it includes details of how these connections will be funded and who will be responsible..

Fig4.1 We have concerns that Figure 4.1 may be interpreted as tending to zero but, as detailed in Appendix 3, the charging function is collared i.e. subjected to a minimum charge and therefore for clarity, suggest this is shown.

4.45 We note Transco's view that further improvements may be achieved through greater disaggregating and welcome further details on this. This potentially feeds into the DN sale process and we encourage Ofgem to start modelling these costs using activity based costing methodology as soon as possible.

5.7 We have concerns that arrangement to mitigate stranded assets run the risk of accelerating geographic pricing faster than anticipated in the 25 year glide path.

5.24 With the administration charge currently at £1.20 for each of the 400,000 supply points, we recognise that with respect to Transco's allowed revenue, this is not a very significant amount. However, we welcome Ofgem's review of this charge to ensure that it remains cost reflective.

5.46 We understand that currently Transco proposes changes to its distribution charging functions and the Authority has the right of veto. Therefore it is not solely for Transco to decide whether the distribution charging functions should be derived in aggregate or individually. Given the significance of this we encourage Ofgem to set up a workgroup with shippers/suppliers to discuss.

We hope these comments have been useful. Please do not hesitate to contact me if you have any questions

Yours sincerely

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Regulatory Issues Manager