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Dear Frances

Review of Transco's structure of distribution charges

Thank you for giving us the opportunity to comment on this consultation. Our response focuses on the key issues identified by Ofgem at the end of chapter 5 of the consultation.

Issue 1: Charge cost reflectivity

Focusing on greater cost reflectivity should in theory provide appropriate signals to shippers, suppliers and their customers that will lead to more efficient decisions with respect to connection to the gas system and consumption of gas. Although greater cost reflectivity is likely to lead to more efficient investment decisions and environmental benefits from greater fuel efficiency, it could undermine other public policy objectives.

Powergen is not against a move to greater regional differentiation of charges provided the impact on customers is properly assessed. We are particularly concerned about redistributional affects that could have an adverse affect on the fuel poor. We also do not want to see the application of different charging methododologies and structures to different DNs. Shippers that supply customers connected to Independent Gas Transporter (IGT) networks already have to deal with any array of different charging structures which add to their costs. Powergen estimates that it costs at least £25 extra per annum to serve domestic customers supplied from IGT networks as opposed to the Transco system. A significant proportion of this extra cost relates to the fact that charging arrangements are different to Transco.

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We believe the current methodologies for establishing the levels of distribution charges are satisfactory. Basing transportation charges on size of customer and the probability of such customers being connected to a particular pressure tier is both fair and easy to administer. We would not support any move to back to distance related charges, which have been demonstrated in studies of the highly interconnected GB system to not be a key driver of transportation costs.

We want the existing methodologies to continue to be applied for each LDZ by Transco, or any new distribution network owner, in a consistent and uniform way. It seems inevitable that different levels of distribution charges will apply given the new fragmented price control structure. This will be accelerated by the future sale of any gas distribution networks. We are unclear however, how the end of postalised GB distribution of charges will be reconciled with Ofgem's previous views suggesting customers will not face real term price increases. In referring to efficiency saving over 25 years in the consultation document, 'Separation of Transco's distribution price control – Final Proposals' dated June 2003 Ofgem stated,

"The figures showed that consumers in all regions of the country should experience real price reductions compared to the present level of charges, but with charging levels diverging between regions over time."

Issue 2: Capacity/Commodity split

We do not support a move away from the 50:50 capacity commodity split. Given we expect charges to change as a result of a move from national to regional cost recovery, it would seem unwise to change the capacity/commodity split (with its own redistributional effects) at the same time. To do so may prejudice Ofgem's implied desire, in the main, to avoid real term increases in charges to particular users.

The proposed greater reliance on capacity charges has worrying implications for the fuel poor. This is because such a change is likely to be reflected in the structure of supplier tariffs (e.g. an increase in standing charges where these apply) leading to a disproportionate adverse impact on many fuel poor customers.

Issue 3: Connection charge boundary

The current shallow policy seems to offer a pretty robust methodology for defining this boundary. It allows new consumers to connect at reasonable cost and ensures all connectees are treated on an equitable basis. A deeper methodology would on the face of it be more cost reflective because the connectee would face the full up front cost he places on the system. However, the costs are unpredictable as these may depend on the timing of a connection and spare capacity already available on the system - free riders may also potentially benefit form the upstream network development paid for by others. It is right that these shared resources are jointly funded with other users through distribution rather than connection charges.

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We would not support an even shallower policy as this would result in other users cross-subsidising the connections which should rightly be funded by new users. In our view, it remains appropriate for the developer to fund network extension costs through connection charges, but that all reinforcement costs should be paid for through on-going distribution charges (subject to the current economic test).

Issue 4: The Economic Test

On the face of it, we agree with Ofgem that the current economic test may appear to be asymmetrical. However, the test does rely on future load flow assumptions over 15 years. There is nothing to guarantee that a substantial reduction in load might not occur within this time frame. If Transco were to reduce the initial connection charges (in the event that predicted transportation income outweighed reinforcement costs) they would be gambling on these load assumptions. This risk means any reduction in connection charge may ultimately have to be paid for by other users. This probably justifies the asymmetry of the test.

Issue 5: RPC regulation of IGTs

The likely move away from postalised GB charges to differential charges linked to LDZ regulatory asset values (RAVs) will inevitably have a knock on effect on RPC regulation. In some areas the linkage to local LDZ charges will make it less attractive for IGTs to invest in those areas, compared to the current uniform GB postalised charges.

Ofgem may be concerned that this could result in unnecessarily high IGT charges in some areas and a reduced number of new IGT developments in others.

Issue 6: Implications of Transco's distribution price control and sale of DNs

Regional differentiation in charges is an inevitable consequence of these changes. Arrangements need to be established to ensure that although charging levels may vary, the uniform charging structures (i.e. consisting of the same charging elements) are maintained across the whole country. Shippers certainly do not want to see a replication of the costly and burdensome IGT charging arrangements within independent DNs. This requires national control and governance of charging methodologies irrespective of the ownership of particular distribution networks.

Failure to put in place these safeguards will inevitably lead to diverse and progressively fragmented charging structures that will benefit no one, not even the distribution companies. Overall it is important that competition in supply is not undermined by unnecessary complexity, undue distribution charge instability and higher shipper costs. We would advocate Ofgem take a cautious measured approach to any future proposed changes to charging arrangements consistent with its belief that customers would not face real term distribution charge increases.

Yours sincerely

Peter Bolitho