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Our Reference:

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Dear Joanna

Gas Distribution Charges From October 2005

In response to your open letter dated 4 May 2005 regarding the above, we have set out below our comments on some of the issues associated with the publication by Transco of indicative gas Distribution Network (DN) charges for October 2005.

Your letter highlights the potential volatility in distribution charges over the next two years and illustrates in several instances that a DN's price increase in October 2005 will need to be followed by a price reduction the following October. A contributing factor for this swing is that in October 2005 the DNs will need to re-balance two years of over or under-recovery, and the charges required to do so will be higher or lower than a steady-state level and therefore a compensating adjustment will be required the following October. Furthermore, there has been a revaluation of formula rates.

It would appear therefore, that the price volatility of 2005/06 is more exaggerated than would normally be expected owing to the delay in moving to network specific charges following the disaggregation of the DN price control and the rates issue. We therefore believe that although we can expect price variations in future, the scale of them is unlikely to be as pronounced as those indicated over the next two years.

Nevertheless, we have considered some possible options below in the context of managing potential charge variations going forward.

1. Incentive arrangements.

Ofgem has suggested that in drafting the next price control licence condition it may be appropriate to consider whether incentive schemes that are calculated annually could be settled over the subsequent five-year period. We would not support this approach. Any attempt to "roll over" the risk/reward associated with an annual incentive scheme would fundamentally undermine the rationale of the incentive for the price-controlled entities

and introduce unacceptable regulatory uncertainty and risk. We firmly believe that incentive mechanisms that are based on an annual performance measure should be settled on an annual basis. In our view, charge volatility is a necessary consequence of risk/reward incentive mechanisms, the perceived “disadvantage” of which (ie charge volatility) is offset by the efficiency drivers associated with the schemes.

Therefore, based on the above and Ofgem’s conclusion that the DN REPEX incentive mechanism does not represent the main driver for the regional price variation being considered in Ofgem’s letter, we would be extremely concerned if Ofgem were to pursue an approach that sought to settle annual incentives over a five year period.

2. Pricing licence conditions.

The new licence requirement for a DN to use reasonable endeavours to only change charges on one date in the year (1st October) could, in our view, increase the future likelihood of the “see-saw” effect. This is because the sooner a price change can be implemented once the need for it has been identified, subject to the notice requirements, the smaller the price change will need to be. The longer the change is delayed the larger the change will need to be to clear accumulated under-or over-recovery, making it more likely that a change in the opposite direction will be needed the following October.

One way to help to reduce the likelihood of this effect would be to allow a DN to change its charges on two dates in the year, say 1st April and 1st October, where it is in the interest of reducing charge volatility to do so. At the very least, if the once a year restriction is to be retained, we believe it would be advantageous to allow the DN the flexibility to choose between 1st April and 1 October.

3. 150 days indicative notice.

In the interest of managing charge changes most effectively, we believe it would be beneficial to review the 150 day indicative notice period. In our view, the period is too extended for transporters to be able to give to give an accurate indication of the size of an expected price change. This is particularly so in the case of price changes on 1 October, for which indicative notice has to be given by 4th May. The networks have traditionally produced volume forecasts in the middle of May each year (after the winter quarter), so that the indicative notice changes have to be calculated on the basis of the previous year’s forecasts, which may by then be well out-of-date.

We therefore believe that there would be merit in shortening the indicative notice period to three months, as this would allow the forecasts to be based on more up-to-date information and therefore notice would be more accurate and more useful. This would also be consistent to the approach that has recently been adopted in electricity where indicative notice periods have been reduced from five to three months. Alternatively, it may be possible to review the timing of the forecasts in attempt to make the indicative charges are more meaningful.

4. Charge structure.

Finally, one of the factors that may contribute to over/under recovery and therefore charge volatility is the extent to which there is a mis-match between the relative sensitivity of charges and allowed revenue to units distributed. This is an area that we intend to investigate over the coming months.

I hope that you will find the above comments useful. If you would like to discuss any of the points we have made, please give me a call.

Yours sincerely

Rob McDonald
Director of Regulation