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Samanta Padalino Head of Gas Distribution Policy Ofgem 9 Millbank London SW1P 3GE

Dear Samanta

We welcome the opportunity to respond to the consultation regarding the structure of gas distribution charges. Our response is attached and is structured to answer the questions as outlined in paragraph 4.83.

Please note that our response can be considered as non-confidential.

Yours sincerely

Alex Wise

Alex Wiseman Regulation Director

<u>Issue 1 – is Transco's estimate of marginal costing robust?</u>

We agree that the majority of marginal LDZ costs are indeed capacity driven. The methodology in Transco's analysis seems robust and we believe it is unlikely that the final outcome on the marginal cost items themselves will have changed materially since then. A new analysis is unlikely to significantly alter the conclusions. However, it is of concern that such a significant proportion of costs are deemed "indirect" and not driven by either commodity or capacity activities. Hence care needs to be taken when making the final decision on the capacity / commodity split.

<u>Issue 2 – which one of the proposed options would be more appropriate for the capacity / commodity split?</u>

Overall, keeping the Use of System charging methodology is an appropriate decision. Moving to a different and possibly more cost reflective methodology may improve investment signals and could increase the efficiency in the system long term. However, it is questionable whether these benefits would outweigh the costs of increased complexity of a different methodology. Therefore, we support Ofgem's decision to continue to use the UoS charging methodology.

Therefore, we welcome the move toward more capacity driven charges as we believe it reflects the underlying costs better than the current split yet avoids the complexities referred to above. However, the main difference between the two new, proposed capacity / commodity split options is determined by the assumption of how to allocate the indirect costs. Transco states in the PD4 that they cannot clearly define these costs as either capacity or commodity driven. Hence, a cautious approach is needed to changes in the capacity / commodity split.

Moving to a 99/1 capacity/commodity split seems an extreme step. It is making an assumption that all indirect costs are driven by capacity activities, which is hard to justify based on Transco's analysis. Further, as Ofgem shows in Table 1.1 in Appendix 1 of the consultation, the 99/1 option will impact consumers to a higher degree. Hence any unintended customer consequences would be magnified compared with the 70/30 option.

The decision should also take into account the outcome of the exit and interruption reform consultations, since the resulting costs will be part of the expenses the gas transportation charges are designed to accurately reflect.

In summary we believe a higher proportion of capacity driven charges will improve the cost reflectivity of the charges. However, due to the uncertainty regarding the allocation of indirect cost we prefer the 70/30 option as it is less extreme and will have less impact on customers.

However, if Ofgem was minded to move to 99/1 we believe that 100/0 would be a better option. The impact of 1% commodity charges would be immaterial on behaviour; however there would be an opportunity to save costs on calculating and allocating commodity charges by eliminating them completely.

The consultation also covered CSEP charges. We believe that the current charges are cost reflective and hence support the proposal to keep reviewing the costs every two years until current process' capacity is reached. Furthermore, funding the automation of CSEP should be addressed during the forthcoming price review.

Issue 3 – risks / impact of shippers introducing standing charges

We cannot predict whether shippers will introduce standing charges as a response to an increasingly fixed charging structure for gas transportation. However, since total gas transportation charges are no more than 25% of a domestic end consumer's bill, and the current charges are 33% fixed (i.e. 8.25% of a current domestic end consumer's bill), there is plenty of room for shippers to absorb any variability rather than resort to a standing charge. Shippers should be encouraged <u>not</u> to introduce a standing charge to ensure that the fuel poor customers are not adversely affected.

Should standing charges be introduced, it is important to note that the extent of any behavioural changes will depend on what proportion of the end consumers' final bill is a standing charge. The higher the proportion, the more pronounced the impact. We believe a small standing charge is unlikely to affect behaviour.

<u>Issue 4 – the Economic Test: whether and how it would be possible to make a</u> robust distinction between process and non-process loads under the ET

We agree that the Economic Test should be retained as it ensures that correct and efficient economic decisions are made. Any changes to the economic test will affect the number of projects passing the test and consequently will affect capital expenditure. Hence the timing of a change to the economic test should be consistent with the price review timetable so that capital expenditure changes can be taken into account within the price review.

It is logical to distinguish between assets with materially different risk profiles and therefore the separation between process loads and non process loads seems reasonable. With regards to the actual definition of process and non-process loads, we believe that it will not be that difficult to come up with a robust definition. A broad definition would be to distinguish between domestic developments versus non-domestic applications; this could perhaps be further developed in a workshop involving interested parties.

We also agree that the two types of loads should be treated differently in the test to reflect their different risk profiles. However, the current proposal's treatment of process and non-process loads does not go far enough to reflect this difference in risk. We agree with the treatment suggested for non-process loads. However, the process load treatment should go further to reflect its higher risk potential. Process loads should have a higher discount rate, a shorter asset life and a shorter appraisal period than that proposed.

Discount Rate

The proposed discount rate matches the current WACC of the price gas transportation price control. The 6.25% gas transportation WACC is based on the risk profile of the overall business of which process load connections is only a small part. The purpose of the ET is to ensure the correct economic decision for each particular case of connections, not for the overall business. Therefore, for the higher risk non-process projects, the discount rate should be greater.

Asset Life and Appraisal Period

We propose that the asset life and appraisal period match for process loads, just like they do for non-process loads. However, an appraisal period of 15 years would be more reflective of the risks involved than the proposed 20 years. The DNs currently bear the entire risk that the new connection will not perform to load forecasts, hence the economic test's parameters need to be stringent to ensure that only those reinforcements that make economic sense for both parties are constructed. Our proposal is for the asset life and the appraisal period to be 15 years.

<u>Issue 5 – the Economic Test: whether the publication of additional information on</u> the ET in the format outlined in appendix 2 would be helpful

We do not see any particular benefit to our customers from the publication of additional information. The model is designed to determine whether a certain load will pay for its own reinforcement or not. The forecast loads provided by our customers are assumed to be as correct as possible. Therefore, the end result, i.e. whether the proposed reinforcement requires a customer contribution, would not change if our customers understood the exact inner workings of the ET. The only customer benefit we can foresee is if the customer decided to let the additional knowledge about the ET impact the forecast input values to minimise their potential contribution. This would undermine the main objective of the ET, i.e. to provide economically efficient decisions. Subsequently, it could have long term adverse customer impacts as gas transporters might be forced to recover some of the shortfall driven by gaming through normal customer charges.

<u>Issue 6 – the Economic Test: whether such information on the ET would lead to</u> <u>gaming by potential new connectees</u>

In our experience, some gaming is prevalent even in the current situation. Therefore it is not an unreasonable assumption that any additional information will be used for similar purposes. Hence we are not comfortable with publishing the details of the test. The Economic Test model is an aid to determine whether a connection can be made efficiently. Currently, the DNs take the risk of not recovering the necessary income if the actual loads used are significantly below what was forecast in the test. If the model was to become more transparent, the connection customer should share some of the risk and guarantee a certain usage level.