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Ms Samanta Padalino
Head of Gas Distribution Policy
Ofgem
9 Millbank
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Dear Samanta,

Re: Structure of gas distribution charges, Initial Proposals, July 2005

Thank you for the opportunity to comment on Ofgem's initial proposals with respect to the structure of distribution charges. In commenting, we would also refer you to our previous response to the May 2004 document, a copy of which is appended to this letter for your convenience.

Centrica acknowledges that Ofgem has taken into consideration many points made by respondents to the May 2004 paper and we hope these comments will also be helpful.

We have structured this response to reflect the order of issues raised in chapter 4, and then conclude by raising another issue we do not believe has yet been addressed.

Issue 1:
<u>Whether Transco's estimate that marginal cost charging would allow DNs to recover only 40% of their costs is robust.</u>
As we have not been privy to the work Transco has carried out in this area, we do not feel competent to assess whether 40% is a robust estimate. However, given previous evidence, it seems likely that marginal cost charging would lead to very significant underrecoveries against their allowed revenue. If this is the case, then before any change is made to this area, we are of the view that a full review of allowed revenue would be required.

Issue 2:
<u>Which one of the proposed options would be most appropriate for the capacity/ commodity split.</u>

We commented at considerable length on this issue in our previous response, and do not propose to replicate those arguments here.

However, we continue to be concerned that either of the proposed changes from the status quo will result in the significant transfer of revenue recovery between large and small users. We acknowledge that simultaneous reform of the interruptions arrangements might be viewed as mitigation for this transfer of costs. However Centrica believes that this would only be the case if interruptions reform is carried out in such a way that costs are minimised and a clear net benefit proven and realised.

In our view, capacity costs should largely be a reflection of sunk or fixed costs, whereas commodity costs will reflect the cost of actually transporting the gas through the pipes and hence will vary with volume. Hence, we believe that a switch to 99:1 capacity/commodity in particular would fail to properly reflect this balance of costs.

We are not persuaded by the Impact Assessment (IA) provided in Appendix 1, though we appreciate that this IA is at a very early stage in its development and will require significant additional work. Our major concerns are twofold; firstly, the IA does not take into account industry development costs (this is acknowledged); secondly, it does not take into account the effect of simultaneously moving the Customer Charges to a wholly capacity based charge.

The combined impact of the two changes together is likely to result in significantly higher charges for many domestic customers, especially low users, than is predicted. As we previously recorded, we also believe that the effects will be adverse for the fuel poor and the vulnerable.

Centrica is also sceptical that moving the capacity/commodity split in this way (plus the change to customer charges) will result in more efficient use of the system, particularly by domestic customers. Domestic usage is relatively inelastic, and moving to a higher proportion of fixed charges is unlikely to change this. Maintaining a significant commodity charge would be expected to feed through to the customer's unit rate, and therefore create the right incentives for overall demand management in and in particular to incentivised progress of energy efficiency. Whilst Ofgem notes AQ is the way that a domestic customer could be expected to influence the capacity charge, we do not agree that this would have the desired effect, as there is no direct relationship between the individual customer's action and the bills they would see in the next period. There could also be countervailing effects which would neutralise any individual action a customer might take.

Centrica agrees with Ofgem that this type of change might well lead to the continuation or re-introduction of standing charges, especially given weather sensitivities. It is extremely unlikely that any supplier would be able to manage the disconnect between revenue and expenditure without doing so. This is likely to prove unpopular with customers and would almost certainly be disadvantageous to low users.

One possible option which does not seem to be addressed would be to leave the capacity/commodity split unchanged for the duration of this control, but consider moving to a capacity based customer charge together with the planned interruption reform. This should be followed by careful monitoring the effect on all groups of customers until the next control.

In addition to the above, Centrica considers that it would be prudent to wait and assess the effect of DN Sales and the separation of the distribution price controls on different customer groups (and customers in different locations) prior to making major changes to the structure of charges. During the discussions leading to DN Sales, it was clear that the intention was for a glide path to operate in respect of charge divergence. It has since become clear that regional differences are arising faster than many anticipated, changes which could well have significant impacts on customers during the five years of the next price control.

Overall, Centrica is of the view that the current split represents a reasonable balance between cost reflectivity and practicality and hence that the status quo should be maintained. We further believe that given the intended reforms to the interruptions regime, it would be sensible to wait and assess the effect of these reforms for the duration of the next distribution price control, before considering further change.

Whilst Centrica could not support a decision to change the capacity/commodity split as proposed, if such a decision is made, we believe strongly that the change should be phased in over at least a five to ten year period.

Issue 3:
What are the risks and consequences of all suppliers introducing a standing charge in the bills of final consumers under Ofgem's initial proposals for changing the capacity/commodity split.

We believe that the main risks associated with these proposals relate to increased costs to serve and hence increased bills. There are clear cost implications under these proposals which need to be assessed against the benefits of changing the current cap/com split. We believe that it is necessary to consider changes required both as a result of standing charges, and as a result of the change in structure of distribution charges, as the two are interrelated.

These include, but are not limited to the following:

- systems changes, both the main systems of shippers and suppliers
- training requirements
- customer literature requirements.
- I&C customers, given the number of small non domestic users, such a change might not be limited to domestic systems, but also impact I&C systems, both for quotations and billing.
- industry invoicing and validation systems, especially in respect of the changes to customer charges.

The likely costs and impacts both in time and money should not be underestimated. If the proposals progress, Centrica believes that a full IA should be undertaken in good time, and sufficient time allowed once the proposals have been refined, for shippers and suppliers to produce robust estimates of cost, based upon a clear picture of what is proposed. We would urge that lessons are learnt from DN Sales in this respect, as the time allowed for cost assessment and change planning was unsatisfactory.

Issue 4:
Whether, and how it would be possible to make a robust distinction between process and non-process loads under the ET.
Centrica is of the view that a reasonably robust distinction should be possible in most cases, however, there are likely to be exceptions to any rule which would need to be catered for. The issue would be whether such exceptions proved to be sufficiently numerous as to invalidate the basic definitions.

In order to make such a distinction, we believe that considerable discussion and research is likely to be required. We would note that in the current ET, Transco is unable to provide a definition of a typical load, which might be considered to call into question the robustness of the application of the current test.

In addition to the above point, Centrica does not support the reduction in asset life from 65 to 45 years. Over recent years, Transco's investment programme has led to a steady increase in the quantity of PE main in the ground (it is now in excess of 50%), which clearly has a longer asset life than cast iron or steel. With this in mind, we do not understand how an overall reduction in asset life for evaluation purposes can be justified.

However, we appreciate that more assets are involved than simply mains in the ground, hence we consider that there may be merit in a reduction in asset life for those assets which can be clearly evidenced to have a shorter useful life than 65 years. This should be based on independently verified testing, and we believe it should be the exception rather than the rule.

We believe that the Ofgem alternatives under 4.67 may be an over-simplification. Historically the creation of new process loads has affected the economics of the gas supply area, which would suggest that there would be very few cases where a network extension serves only a process load.

Issue 5 & 6:
<u>Whether the publication of additional information in the ET in the format outlined in appendix 2 would be helpful; and whether such information on the ET would lead to gaming by potential new connectees.</u>

Centrica is of the view that Transco's concern in this area is reasonable and should be addressed, though we would also support a greater degree of transparency if a robust protective mechanism could be put in place.

We believe that it is appropriate that stringent tests are required in respect of new loads connecting and we would be reluctant to see the protection afforded by the ET weakened.

It would seem reasonable that a form of long term agreement could be put in place with new loads. An example would be: if the final load that was placed on the system differed over the 5 year increments of the appraisal period by more than an agreed deadband (either side of the predicted value for the increment), then an appropriate sum related to the variation would become payable.

Additional Issue:
<u>Distribution charges in respect of the Statutory Independent Undertakings and Scottish Independent Networks</u>

At present, customers in the Statutory Undertakings (Llanfyllin, Llanwyrtd Wells, Colden and Stornoway) are charged distribution charges related to the average national distribution charge across England, Scotland and Wales. The difference in cost is then collected via distribution charges as a whole. Centrica is of the view that it would be simpler, more equitable and more cost effective for these customers to be charged in accordance with the charges prevailing in the surrounding DN.

We raised this issue during the discussions on DN Sales, and it has not yet been fully resolved. We believe that it would be appropriate to address this issue as part of these early discussions in preparation for the next price controls, which will allow ample time for any minor adjustments required to the GT licences or the Secretary of State's determination.

We hope the above comments have been helpful, but should you with to discuss any points in more detail, I would be happy to help.

Yours sincerely,

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Regulatory Issues Manager

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