Scottish and Southern Energy

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26 September 2005

Dear Samanta,

Structure of gas distribution charges – Initial Proposals

You have invited comments on the Initial Proposals for the Structure of Gas Distribution Charges and I am pleased to set out our comments below. Overall we are pleased that Ofgem has concluded, with the exception of the capacity/commodity split, that only marginal changes, and at minimal cost, may be required.

We do however have a concern about the proposed timetable. The proposal to implement changes on 1 April 2006 is not compatible with the licence obligation on DNs to change charges only on 1 October each year, and does not allow for the required consultation/notice periods. For the reasons we set out in further detail below, we believe that 1 October 2007 would be a more realistic date for implementation of the changes as directed.

The Initial Proposals ask for views on a number of issues, we deal with each of these in turn below.

<u>Cost reflectivity of use of system charges</u>

We agree with Ofgem's conclusion that there are not sufficient reasons to justify changing the charging model at present. Further, as a principle, we do not support the introduction of distance related charging in gas distribution. This is because distribution networks are very complex with variable gas flows and it is not clear how a distance related charging structure could be developed which would be transparent, fair between users, and practical from an implementation point of view. For instance, the actual distance from an NTS offtake to a supply point may bear no relation to the distance the gas travels to reach the supply point, and the latter distance may vary from day to day depending on network conditions.

<u>Capacity and Commodity split</u>

We do not agree with Ofgem's proposal that any change in the capacity/commodity split is introduced in conjunction with the reform of the existing interruption regime. We consider that if it is determined that a move to an increased capacity/commodity split is appropriate, it should be considered on its own merits and in the context of the charging methodology objectives.

We are also of the view that more time is required for proposals to be developed and considered in depth. This is particularly important in the case of the new iDNs which will need time to examine the cost structures of their networks to see if they agree with the figures produced by Transco. It is therefore our view that it is too early to narrow the options down to a 70:30 split or a 99:1 split. The options should only be finalised after the iDN's have examined their cost structures and made their own proposals.

We believe that the earliest the analysis could be carried out and appropriate proposals developed to change the capacity commodity split would be in time for a price change on 1 October 2007, and which would also be consistent with the proposed timescale for the revised DN interruption arrangements.

Notwithstanding the above, we do acknowledge that in the event that interruption reform is implemented in October 2007, any change to the capacity/commodity split should be introduced before or at the same time as such reform, in order that the DN can make trade-offs between investment in new capacity vs the costs of interruption contracts with shippers. A key element to be considered as part of that process will be the capacity element of the transportation charge which will need to be known to both the DNO and the shipper as part of that decision making process.

With respect to whether Transco's estimate that marginal cost charging would allow DNs to recover only 40% of their costs is robust DNs need to have access to the detail behind the Transco calculations and then time to gather the information and perform the calculations with respect to their own networks.

The Initial Proposals also ask 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? The effect of making a greater proportion of the charge capacity based would be to bring the weather sensitivity of billed and allowed revenue more in line, so that as volumes vary with temperature the impact on billed revenue and allowed revenue would be similar. This would reduce the amount of over- or under-recovery experienced by the Networks and reduce the magnitude of price changes. Another consequence would be that domestic consumers' bills would be at least in part more predictable, but also that small domestic users would probably end up paying more.

<u>The Economic Test</u>

The Initial Proposals conclude that the Economic Test (ET) should be retained since it provides some locational signals on the costs of connection, which are not provided by UoS charges. It can also help to protect existing customers from having to cross subsidise new loads with atypical profiles or those which disconnect prematurely from the distribution system. We support these conclusions.

Ofgem also considers that some aspects of the ET need to be reviewed. The Initial Proposals suggest that the appraisal periods for new loads should be reviewed, with a new distinction between process and non-process loads. Ofgem also suggests that some parameters of the ET need updating, in particular the discount rate used and the depreciation period, and it seems sensible to align these with those assumed in the price control.

Introducing different appraisal periods for process and non-process loads could make the ET easier to achieve, but also more sensitive. In our view, further analysis is needed to consider what those appraisal periods should be and whether a realistic distinction between process and non-process loads is in fact possible in most cases

It is also not clear that a robust distinction could always be made between process and non-process loads, or even that the transporter is always entitled to ask for this information. There will be cases where the new load is part process and part non-process. It might be appropriate to depreciate assets over the lower of 45 years or the design life of the proposed connection.

The Initial Proposals also ask whether the publication of additional information on the ET in the format outlined in Appendix 2 of the document would be helpful? In our view, the publication of the information probably would be helpful in allowing new connectees to understand how the ET is applied. However it would also make it easier for new connectees to game by presenting projects in the most favourable way. It would be possible to offset this risk by having the customer guarantee his requirements for a period of time, as is the case in electricity.

CSEP administration charge

We generally support retaining the status quo but fail to see what the proposal, that DNs should review the costs underlying the CSEP administration charge every two years on [say] 1 October, adds to the existing licence obligation to keep charges under review at all times. It also seems sensible that DNs should also undertake and consult on a cost-benefit assessment of switching to an automated system if the unit cost of processing data under the existing system starts to increase or if it is reaching its capacity limit. Introduction of an automated system would be dependent on the outcome of the cost-benefit assessment.

Surveys and auditing

The Initial Proposals note that some key data sources used by Transco as inputs to its charging functions need to be reviewed or updated. Ofgem has identified a number of data sources that should be updated, including:-

- The cost of growth figures used in the Economic Test;
- The connection by pressure tier surveys used to derived the system capacity and commodity charging functions;
- The ABC cost analysis.

We agree with Ofgem that these data sources need to be either updated and/or reviewed but also stress that they need to be done on a DN basis in order for the results to be useful in a review of the DNs' own charging functions. It will take the iDNs some time to do this. We also stress that all the information available to Transco from the previous surveys and cost analyses on a national basis should be made available to the iDNs as this would help them in structuring and scoping their own surveys and analyses.

Next steps

We agree that Ofgem's proposal that any changes in the level of charges and/or the charging methodology associated with Ofgem's Final Proposals for the capacity/commodity split could be implemented on 1 October 2007.

However the proposition that Ofgem's Final Proposals for all areas of the structure of gas distribution charges except the capacity commodity split should be implemented on 1 April 2006 seems to propose an unrealistically short timescale, in particular when realising the obligatory 150 days notice period. Further, there is simply not enough time between now and December 2005, when Ofgem propose to publish their final proposals, for any useful DN based analysis to be done, particularly on the ET and the customer charge.

It might be possible to implement some other changes on 1 October 2006, but 1 October 2007 would be a more realistic date. Adopting a time-scale based on 1 October 2007 would also allow a co-ordinated approach to be taken to the whole structure of charges.

One final technical point is that it would be advisable to check whether Xoserve's billing systems will be able to accommodate changes to the charging methodology as early as April 2006. We understand that the amendment of the billing systems to cope with differential levels of charges within the same methodology has in itself been a major task. The costs to DNs, and to shippers, of these changes need also to be taken into account and allowed for in the price control.

I hope that our comments above are helpful. If you wish to discuss any of the points raised, please call.

Yours sincerely

Rob McDonald
Director of Regulation