This letter is addressed to
National Grid Distribution;
Northern Gas Networks; Scotia
Gas Networks and Wales and
West Utilities

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Dear Colleague

GDN interruption reform and application of the Economic Test under SLC 4B of the GT Licence

Introduction

1. The Economic Test (ET) is currently applied by the Gas Distribution Networks (GDNs) under Standard Licence Condition (SLC) 4B – Connection Charges etc of the Gas Transporters (GT) licence. The test compares the upstream system reinforcement costs and additional operating costs associated with new and incremental requests for capacity (including requests from interruptible customers for firm capacity) with the transportation revenue associated with the new capacity. Where projected costs exceed projected revenues discounted over the appraisal period, a financial contribution is payable to the GDN by the customer requesting the new capacity.

2. In January 2007 the Gas Distribution Networks (GDNs) published an information note via the Joint Office of Gas Transporters titled 'Interaction between the Economic Test and DN Interruption Reform'. The note highlights the GDNs' view that the reformed interruption arrangements require changes to the way the Economic Test (ET) is applied, and sets out the way the GDNs propose to apply the ET under the reformed arrangements.

3. On 15 March 2007 Ofgem directed implementation of UNC Mod 90 'Revised DN interruption arrangements' with effect from 1 April 2008. In our decision we considered that the mod proposal as presented was likely to facilitate better the achievement of the relevant objectives as set out in Standard Special Condition A11 (1) of the gas transporters licence. We did not and do not consider that the proposal's ability to facilitate better the achievement of these objectives will be dependent on how the ET is applied under the reformed arrangements. For this reason we considered that it was not appropriate to try to resolve the issues raised in the GDNs January information note in the context of the UNC Mod 90 decision.

4. In our Final Impact Assessment on interruption reform[1] we acknowledged that the application of the ET under the reformed interruption arrangements would need to

[1] Reform of interruption arrangements on gas distribution networks – Final Impact Assessment, Ofgem, 15 March 2007 This IA directly informed Ofgem's decision to implement the Mod 90 proposal

be addressed ahead of the first interruptible capacity auctions. In directing implementation of Mod 90 from April 2008, we noted that the decision taken to delay implementation by one year would provide time for a review of the issues raised in the GDNs January information note. In the period since our decision on Mod 90 we have taken the opportunity to consider the merits of the GDNs proposals in more detail. This letter explains Ofgem's views on the interaction between interruption reform and the ET, comments directly on the proposals outlined in the GDNs January information note, and invites the GDNs to reflect further on the best way to incentivise efficient use of network capacity in the period following implementation of interruption reform.

GDNs proposed application of the ET

5. The GDNs' information note describes the GDNs' proposed application of the ET across three categories of customers and time periods: namely, customers currently interruptible under the existing interruption arrangements; customers seeking new or incremental firm capacity in the transitional period between the first interruptible auctions taking place and the time three years later when the first interruptible capacity rights take effect; and customers seeking new or incremental firm capacity in the period after the first interruptible capacity rights take effect.

6. The GDNs have proposed that existing interruptible customers re-designated firm following the first interruptible capacity auctions should not be subject to the ET. Under the reformed interruption arrangements GDNs will contract only for the volumes of interruptible capacity that they require and so customers will lose the right to unilaterally nominate themselves interruptible. This contrasts with the existing arrangements where customers can nominate themselves as interruptible. In situations where reinforcement would be required to support a customer as firm, the flexibility of the existing arrangements can have the effect of removing the need for the reinforcement thereby allowing customers to connect without having to make an upfront payment. The GDNs consider that it would be unreasonable to apply the ET to customers who will no longer have this flexibility and who will already have taken a decision on where to connect on the basis of the existing regime.

7. For customers seeking new or incremental capacity in the transitional period, and for customers seeking new or incremental capacity in the period after the first interruptible rights take effect, the GDNs' information note sets out that the GDNs consider that the ET continues to have a role to play in their connection charging methodologies. Since interruptible rights will only be allocated via the interruptible capacity auctions, the GDNs take the view that interruption reform confers firm capacity rights on all customers by default. Since all customers connecting to the distribution networks following the implementation of interruption reform will have the potential to take a firm connection, the GDNs consider that it would be appropriate for the reinforcement costs associated with such connections to be evaluated based on the assumption that the connection will be firm. Consistent with the current arrangements the GDNs consider that this application of the ET will have the effect of maintaining the incentive on customers to make efficient use of the existing pipeline network.

8. The GDNs information note also confirms that the GDNs consider that contributions received as a result of applying the ET should continue to be treated as contributions against capital expenditure, but it is not clear from the note when such contributions would be payable by customers who are successful in agreeing interruptible terms (i.e. upfront or on receipt of the firm capacity). We further note that although there appears to be agreement over the principle of whether the ET should apply to new and incremental requests for capacity in the period beyond interruption reform, we are aware that there is not unanimity between the GDNs over whether this means that the ET should be applied to new capacity in the transitional period, or whether it should only be applied following the new interruptible rights coming into effect.

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From discussions Ofgem has held with the GDNs we are aware that these are issues on which the GDNs have not taken a final view, but we would note that both are relevant in evaluating the practical implications of applying the ET post interruption reform.

Implications of GDN proposals

9. The GDNs' proposal to suspend application of the ET to existing interruptible customers has a number of potential implications. These include the impact on the generality of customers; the impact on existing interruptible customers; and the impact on the GDNs obligations regards undue discrimination under Section 9 of the Gas Act (1986). The size of the impact on each of these factors will be driven to a significant extent by customer behaviour in the first interruptible capacity auctions. If customers currently known as Networks Sensitive Loads (NSLs) participate in the interruptible capacity auctions the impact of the GDNs proposals is likely to be low. If NSL customers elect not to participate in the interruptible capacity auctions the GDNs proposals potentially take on more significance.

Impact on generality of customers

10. In our Final IA on interruption reform we took the view that there are good reasons to suggest that customers formerly known as NSLs will have a strong incentive to participate in the reformed interruptible capacity auctions and we continue to consider that this is likely to be the case. Under the existing interruption arrangements NSL supply points have the highest probability of being interrupted and are among the most likely to have alternative fuel arrangements in place to cope with being interrupted. As a consequence they are likely to have a low marginal cost of being interrupted relative to customers who have not made this investment. In addition, due to the location of NSLs on the pipeline network, under the reformed interruption arrangements, NSLs' interruptible capacity is likely to be highly valued by the GDNs. This may result in it being efficient for GDNs to accept interruption bids from interruptible sites formerly known as NSLs at a rate higher than the equivalent of the current capacity charges discount. We would also note that in the event that reinforcement takes place, customers benefiting from a firm connection would have a much reduced probability of being required as interruptible in the future and so would be unlikely to receive future interruptible capacity payments. In our view, these factors combined, will provide a strong incentive on interruptible customers currently designated NSLs to bid in the interruptible auctions.

11. In October 2007, as part of the GDPCR BPQ process, Ofgem received submissions from each of the GDNs concerning the costs of investment necessary to remove all locational constraints on their networks. From this information we have estimated that across all distribution networks this cost would be approximately £75m. If the ET is suspended and NSL customers elect to go firm, the impact on the level of transportation charges faced by the generality of customers would equate to the difference between the discounted cost of this investment and the increased transportation revenue that the GDNs would recover from NSL supply points paying firm transportation charges. Discounted over a forty five year period using the cost of capital modelling assumption published in updated proposals on GDPCR[2] (4.84% vanilla WACC), £75m of investment would equate to an annuitised value of about £4m. Based on 1 October 2007 distribution network capacity charges, the increased revenue that the GDNs will recover from customers currently nominated NSLs paying full transportation charges, would be in the region of £2.3m. This would leave a potential shortfall somewhere in the region of £1.7m. To put this figure in context, allowed revenue across all GDNs for the one year price control is £2.5 billion in 2007/08 prices. On the basis that the maximum impact on the generality

[2] Gas Distribution Price Control Review Updated Proposals Document, Ofgem, 24 September 2007

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of customers would be less than 0.1% of total allowed GDN revenue, and that through the GDPCR capacity outputs incentive the GDNs will have a strong incentive to contract for interruption to avoid undertaking additional capital expenditure, we consider that the materiality of this issue to the generality of customers is of limited potential impact.

Impact on existing interruptible customers

12. The principal reason why the GDNs consider that the ET should be suspended in the case of existing interruptible customers relates to a concern that it would be unreasonable to request a financial contribution towards reinforcement from an interruptible customer if that customer had been unilaterally re-designated firm by the GDN following the first interruptible capacity auctions. We would agree with the GDNs that such an outcome would not be desirable, but having looked at the issue in some detail we are not convinced that such a scenario is likely to be realised. If a GDN does not contract for interruption in a given area, it is implicit that customers in that area can be accommodated as firm without reinforcement and so no customer contributions would be required if the ET was applied. Conversely, if a GDN does require interruption in a given area and turns down the interruptible offers received, it is implicit that the offers are in excess of the discounted cost of the reinforcement and would be inefficient to accept.

13. If the ET was to continue to apply to existing interruptible customers, at the interruptible capacity auctions it would be rational for GDNs to accept bids for interruptible capacity up to the amount equivalent to a customer's full transportation charge. If the GDN accepted a bid higher than this amount then the generality of customers would be worse off, because the distributional effect on the level of transportation charges of paying the customer to be interruptible would exceed the revenue recovered from that customer in increased transportation charges. Because LDZ capacity charges may not fully reflect actual network costs at each different point on the network, the point at which this threshold is reached may not deliver efficient trade-offs, but given that customers would have had advance knowledge of the level of bid which was likely to be accepted by the GDN, we would not agree that in this circumstance a customer was being forced to contribute towards the reinforcement costs of a firm connection that they did not want. On this basis we do not necessarily agree with the GDNs' concern that it would be unreasonable to request a financial contribution towards reinforcement from existing interruptible customers re-designated firm as a consequence of interruption reform.

Compatibility with Mod 90

14. Aside from a theoretical understanding of the likely outcomes at auction, we would acknowledge that there are a number of practical factors which could make applying the ET under interruption reform complex. The first of these relates to the fact that if the ET is applied to existing interruptibles it may be necessary to apply it in a way in which it is not currently utilised. Under its existing application the ET is applied to one customer at a time and as a result the size of the financial contribution triggered by the reinforcement is clearly attributable. If a number of customers on the same part of the network are re-designated firm simultaneously this may make the process of allocating reinforcement contributions more opaque. Similarly, there is likely to be some uncertainty over how contributions might be allocated where a reinforcement is triggered which would remove the need for several interruptible customers, not all of whom want to go firm. In this situation it is implicit that some customers will have bid for interruptible rights at a rate which makes it economic for them to be accepted as interruptible, but because the GDN is not able to contract for the full volume of interruptible capacity it requires in a particular location, an investment is triggered which removes the need for all interruptible customers in that location.

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15. A further potential complexity associated with applying the ET to existing interruptible customers relates to the fact that in advance of the interruptible capacity auctions it would be necessary for customers to know what interruptible price would trigger reinforcement, and what their reinforcement contribution would be if reinforcement was triggered. This would suggest that the GDNs would have to publish maximum bid prices as part of their interruption tender invitations. It was not explicit at the time of the Mod 90 decision that this type of bidding arrangement would be necessary and so a change of this nature would require an industry consultation. At a time when the industry is stepping up preparations for implementation of the first interruptible auctions as directed under Mod 90, the timing of such a consultation could be viewed as having an adverse affect on the interruption reform process.

Application of the ET and discrimination between users

16. In reviewing the GDNs proposed application of the ET under interruption reform, we have taken the opportunity to consider further the interaction between application of the ET in its current format and the GDNs obligations regards undue discrimination in the connection of premises. In looking at this issue we note, that the justification for application of the ET in the first instance, arises from the fact that capacity charges levied by the GDNs are tiered according to load band and do not accurately reflect the costs of providing capacity in specific locations. Because charges are not fully cost reflective at all points on the network, in some cases the transportation revenue a GDN will recover from a group of customers over the lifespan of an asset, will not meet the financial cost incurred in providing it.

17. To compensate for this weakness, application of the ET requires the customer "deemed" to have triggered the investment to make an upfront payment to meet the financial shortfall, but since customers already connected to the network have not made any long term commitment to use and pay for existing capacity, it is not clear why it is only the last customer to connect who should be liable for meeting the cost of the additional investment. If existing customers ceased to use the capacity (for example if business users closed their production facilities) the reinforcement would no longer be necessary. It may be appropriate to ask a customer to make a contribution if it can be demonstrated that the customer has a higher risk than existing customers of not using capacity, but if this cannot be demonstrated, a GDN may be discriminating unduly in seeking to impose a contribution on a customer deemed to have triggered an investment.

18. In Ofgem's view, if a future application of the ET is to be considered non discriminatory, it must be demonstrable that the customer to whom the ET will apply is objectively different from other customers on the network. If a GDN can demonstrate that one customer has a higher risk relative to other customers of coming off the system, then it is possible that justification could be made for structuring their capacity payments differently. If a GDN proposes to apply the ET in conjunction with the existing distribution network transportation charging methodology, then it is less clear that this would be the case. In our view a customer seeking to contest application of the ET under these circumstances is likely to be able to present a case for undue discrimination on the grounds that other relevantly similar customers on the network are not asked to pay fully cost reflective transportation charges.

19. We recognise that the existing application of the ET is a legacy of the GDNs established transportation charging methodology and that any proposed changes to the methodology will not be deliverable without a full industry consultation and further work on behalf of the GDNs and Ofgem. Nevertheless, on the basis of the shortcomings of the existing application of the ET summarised above, and the criteria regards discrimination which we consider should apply to any proposed future application of the ET, we are of the view that the GDNs proposals to suspend

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application of the ET to existing interruptible customers in the move towards interruption reform, while seeking to re-introduce it uniformly to new and incremental requests for capacity in the period following reform, would be unduly discriminatory. If the limited materiality to the generality of customers of not applying the ET, combined with the potential complexity of applying the ET in conjunction with the first interruptible capacity auctions, means that it is preferable for the ET not to apply to existing interruptible customers, then we would suggest that it would not be appropriate for the GDNs to reintroduce the ET following implementation of interruption reform.

Summary and next steps

20. In this paper we have looked at a number of issues to do with application of the ET in the context of interruption reform. We have highlighted that in our view fears over the detriment to existing interruptible customers of continuing to apply the ET may be overstated. We have also noted that the likely materiality of this issue suggests that the potential impact on the generality of customers is likely to be small. Weighing the potential benefits of continuing to apply the ET against the potential complexity of making its application compatible with the interruptible capacity auctions, we take the view that an insistence that the ET should apply in the short term to existing interruptible customers re designated firm as a consequence of interruption reform would not be appropriate.

21. Taking this view into account, and reflecting our view that the current application of the ET is itself discriminatory, we further consider that the proposed long term application of the ET should be reviewed. We acknowledge that the existing application of the ET is an established part of the GDNs connection charging methodology, but we consider that the move towards the reformed interruption arrangements represents an opportune time for the GDNs to undertake a wider review of the ability of their charging methodologies and current application of the ET to optimise economically efficient allocations of network capacity.

22. The GDNs intend to publish a draft interruptible capacity charging methodology in November 2007. It is intended that resolution of the issues raised in this consultation will directly inform this methodology. We consider that the views expressed in this paper do not affect the GDNs intention to suspend application of the ET to existing interruptible customers, but we take the view that it would be appropriate for the GDNs to reflect further on whether it is appropriate to reintroduce the ET to new customers following interruption reform. If you would like to discuss any part of this letter please contact Lewis Hodgart by phone on 02079017021 or by e-mail at lewis.hodgart@ofgem.gov.uk.

Yours sincerely

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