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Dear John,

Response to DNPC03 – LDZ System Charges Capacity Commodity Split and Interruptible Discounts – Draft Impact Assessment

Thank you for the invitation to respond to this draft impact assessment. This response is sent on behalf of National Grid Gas' distribution (NGGD) business. The response is structured around the questions in each chapter of the draft impact assessment.

Chapter 2. Key Issues

Question 1: What are respondent's views on our assessment of the proposal against the objectives of the distribution charging methodology?

We consider that Ofgem's assessment of the proposal against the second and third criteria of the objectives of the distribution charging methodology is appropriate. However, we believe that the proposal is stronger in terms of the first criterion – cost reflectivity – than is acknowledged by Ofgem.

Firstly, although the data provided within DNPC03 showed that around 30% of NGGD's costs reflected in the LDZ system charges are not directly-related to the level of capacity, this does not imply that they have no relationship to capacity. For example, the level of Formula Rates is related to the value of the NGGD business in terms of its earnings. Since we have shown that the majority of the business direct costs relate to capacity (66% out of 71% direct costs for NGGD) it is reasonable to state that the large majority of the Formula Rates cost relates indirectly to the level of capacity.

Secondly, the "Other Overheads" costs within the indirect costs relate to activities which are typically undertaken in support of the direct cost activities. Where services are provided by NGGD to third parties and charged for in a cost-reflective manner, for example the provision of emergency services to IGTs, then an appropriate proportion of all overheads is added to the direct cost in order to determine the full level of cost which should be reflected in the charge. The level of overhead added depends on the type and nature of the direct costs, reflecting the variation in the nature of the overhead costs.

The large majority of the direct costs which are commodity-related are the costs of the shrinkage gas itself; there is only a very low level of direct internal cost in the commodity-

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related costs. Thus, taking into account the overall relative direct cost levels, if the "Other Overheads" costs were to be apportioned to the direct cost activities then it would be appropriate to apportion virtually all of the costs to the direct capacity-related activities.

For NGGD, Formula Rates costs are 16%, and "Other Overheads" 13%, of the total level of cost reflected in the LDZ system charges. For the above reasons, it is appropriate to apportion the large majority of these indirect costs to the activities whose direct costs are related to capacity. This results in close to 95% of the costs reflected in the LDZ system charges being directly or indirectly related to the level of capacity. We thus consider that the proposal would result in a much more cost reflective charging methodology than the current methodology.

Question 2: What are respondent's views on which elements of Use of System costs are related to system capacity, system throughput or neither?

The DNPC03 consultation paper reflects NGGD's view of how direct costs are related to system capacity and throughput. As covered in our response to Question 1, we consider that the large majority of the other costs are indirectly related to the level of system capacity.

Question 3: What are respondent's views on how best to recover costs that are neither related to system capacity or system throughput?

As stated above, we consider that the large majority of the non-direct costs are indirectly related to the level of system capacity. Where there is no relationship between the level of indirect costs and the direct costs, for example the cost of the PGT Licence Fee, then allocation of the indirect cost proportional to the direct costs would seem appropriate. For such costs, this approach would be equivalent in effect to the equi-proportional mark-up approach suggested previously be Ofgem.

Chapter 3. Distributional Impacts

Question 1: What are respondent's views on the methodology used to determine the distributional impacts of the proposal?

We consider that the methodology used by Ofgem to determine the distributional impacts is appropriate. Ofgem's analysis indicates that the load factor of the supply point is the key determinator of the proportional impact on Use of System charge levels. This is consistent with the relationship shown in the analysis within the DNPC03 consultation paper.

Question 2: Can respondents identify any additional distributional impacts that have not been included in our analysis?

We have not identified any additional distributional impacts.

Question 3: How do respondents view the proposal as it relates to interruptible supply points?

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We consider that the proposal is appropriate in relation to interruptible supply points in that the application of 47.37% of the increased LDZ capacity charge will maintain the value of the discount received by interruptible supply points at the level provided under the existing methodology. Given the UNC Mod 0090 changes to the interruption regime, the continuation of the existing level of discount in the interim period (2008 to 2011) seems appropriate.

Ofgem's analysis, and that contained within the DNPC03 consultation paper, shows that the distributional impact on interruptible supply points could vary considerably between interruptible loads reflecting the large variations in load factors. The proposed application of capacity charges for interruptible supply points will lead to the level of booked capacity in respect of interruptible supply points having a substantial impact on the level of transportation charges; we would expect this to lead to many of the booked capacities being re-evaluated, so improving the quality of data held in respect of interruptible supply points. Better quality data should improve the cost-reflectivity of the transportation charges.

Chapter 4. Other Impacts

Question 1: What are respondent's views on our analysis of the impacts that might result from implementation of the proposal?

We agree that the impact of the proposal on the other policy areas identified by Ofgem will be small.

Question 2: Do respondents have any additional information with regard to possible environmental impacts?

We have no additional information.

Chapter 5. Unintended Consequences

Question 1: Can respondents identify additional significant unintended consequences?

No additional significant unintended consequences have been identified.

Question 2: What analysis would respondents like to see with regard to bi-annual adjustments to charges?

We have no requirement for any analysis for our own purposes.

Chapter 6. Cost Benefit Analysis

Question 1: Do respondents agree that we have identified all relevant costs and benefits?

We think that all relevant costs and benefits have been identified.

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Question 2: Do respondents believe that our quantification of costs and benefits is correct? Interested parties are requested to provide information about any costs and benefits they can identify, which will inform our final IA?

We consider that the customer benefits of the proposal have not been fully acknowledged. One of the benefits of the proposal is that, in conjunction with the proposed structure of the distribution price control for the next five years, it should virtually eliminate income variations and under/over-recovery impacts due to throughput variation caused by weather. The uncertainty around this impact makes it difficult to predict the future level of transportation charges at present. Greater predictability of transportation charge levels should reduce the level of risk for shippers and suppliers and hence facilitate competition between them which, in a competitive gas supply market, should ultimately benefit gas consumers.

In terms of risk analysis, greater predictability of transportation charge levels reduces risks for shippers across years. The proposal can therefore be considered to reduce overall industry risks when considered across a number of years.

If you need further clarification on any points raised in this response, please do not hesitate to contact me.

Yours sincerely,

Steve Armstrong

By email