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Dear Lewis

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

I am writing in response to your open letter addressed to each of the Gas Distribution Networks (GDNs) dated 25 October 2007. In that letter, you discussed a number of points relating to the application of the Economic Test (ET) in the context of DN interruption reform as well as setting out Ofgem's views on the application of the ET more generally. We have therefore taken this opportunity to respond the points you have made in your letter. In particular, we do not accept Ofgem's point that the current or future application of the ET in its current form is discriminatory.

GDN's proposed application of the ET

Paragraphs 5 – 8 of your letter describe the information note that was published by the GDNs in January 2007 that set out how the GDNs currently apply the ET and how they propose to apply it going forward, both in the transition and enduring periods (as explained in paragraph 5 of your letter). This included not applying the ET to existing interruptible customers being designated as firm on 1st October 2011; and the continued application of the ET in the transition and the enduring period.

In response to this note, and following detailed discussions with the GDNs over the summer, we understand that Ofgem has essentially reached three conclusions. In summary these are:

1. Ofgem has concluded that the application of the ET to existing interruptible customers going firm at 1 October 2011 would be inconsistent with the DN

interruption reform consulted upon under Mod 90 and approved for implementation from 1 April 2008.

2. Given point 1. above, Ofgem believes that the proposed use of the ET in the enduring regime as described in the note is discriminatory.
3. Notwithstanding points 1 and 2 above, Ofgem believes that the use of the ET in itself is discriminatory.

We have commented on each of these conclusions in turn below.

1. Application of the ET under Mod 90

As you will appreciate from our various meetings and discussions over recent months, we agree with Ofgem's conclusion that it would be inappropriate to apply the ET to existing interruptible customers going firm as a result of Mod 90. As we have explained during our discussions, one of the fundamental and underlying principles of Mod 90 is that these customers automatically become firm connection points from 1 October 2011 with no application of the ET. It was upon this basis that Mod 90 was directed for implementation by Ofgem and, therefore, to do anything otherwise would, in our view, raise considerable process issues.

We acknowledge that Ofgem has previously¹ expressed an intention to review the appropriateness of the ET as part of the development of the DN interruption reform. However, this did not happen at the time the reform was being developed nor did Ofgem raise it for consideration during its impact assessment on Mod 90 prior to directing its implementation. Had Ofgem considered the ET to be an important part of the GDN interruption reform we would have expected it to have been a feature of Ofgem's proposed model at the time the framework of the reform was being established.

Given the above, and Ofgem's agreement with the GDNs that it would be considerably more complex to manage the application of the ET to these customers in this context and the minimal benefit to the wider customer base, we welcome Ofgem's conclusion that it is not appropriate to apply the ET to the existing interruptible customers as we move from the transition to enduring GDN interruption arrangements.

2. The application of the ET in the enduring regime

Following on from the above, in paragraph 19, Ofgem concludes that if the GDNs do not apply the ET to the existing interruptible customers going firm whilst applying it to new customers seeking a connection from 1 October 2011 it would be unduly discriminatory. We do not agree. In our view, the interruptible customers to which the ET would not apply are a completely different set of customers to those that it would apply to in the enduring regime and therefore, for a number of reasons, it is not unduly discriminatory to treat them differently.

¹ Conclusion on the review of the structure of gas distribution charges, 28 February 2006.

First, the existing interruptible customers are becoming firm through no choice of their own. Rather, they are being required to become firm as part of a regulatory change to the regime whereas new customers requesting a connection do so in the knowledge that they will only be able to connect on a firm basis and in doing so will be subject to the connections policy that applies at the time they make that initial connection, which in this instance, includes the application of the ET.

Second, both categories of customer i.e. existing interruptibles and new connections will have been treated equally in that each of them has/will have had the relevant connections charging policy applied to them at the time of their connection request.

Based on the above, we do not accept Ofgem's assertion of undue discrimination going forward based on the agreed position that the ET would not apply to the existing interruptible customers going firm and the continued application of the ET to new connections in the enduring regime.

3. The application of the ET in general

Paragraphs 16 – 18 of your letter discuss the use of the ET in the context of cost reflectivity and conclude that its continued use could be discriminatory. We are surprised that Ofgem has reached this view given that as recently as February 2006 Ofgem endorsed the use of the ET alongside the GDN transportation charging methodology. In particular, in its conclusion of the review of the gas distribution charging methodology² Ofgem set out its view that:

“the ET can provide useful locational signals on the cost of connecting new loads which are currently not offered by UoS charges. More generally, the ET can identify loads for which there is a higher risk that they will not pay sufficient distribution charges to cover the costs of connecting them to the GDNs. This could result from atypical profiles, premature disconnection from the network or location in areas where it is significantly more expensive to transport gas. As a consequence, other customers may be required to pay higher distribution charges to fund the shortfall between the distribution charges paid by a specific load and the costs of the capacity investment that such a load has required.”

Notwithstanding the above, paragraph 16 of your letter explains that the justification of the ET arises from the fact that capacity charges are not site specific. Ofgem therefore seems to be saying that if charges were fully cost-reflective the ET would be unnecessary. This is true, however, fully cost reflective charges imply a deep connections charging methodology with either the full costs of specific reinforcement being recovered through the (site specific?) transportation charges or as part of the connections charge. We note however that a deep, fully cost reflective regime was rejected by Ofgas in 1998 when Transco was directed to adopt a shallow connections policy.

² See earlier footnote 1.

Our understanding of the discussion in paragraph 17 of your letter is that Ofgem believes the ET is required to compensate for the “weakness” of non cost-reflective charges. This is not the case. The ET is required to compensate for the application of a shallow connections policy to protect the generality of consumers where greater than average reinforcement costs are triggered by a particular load seeking to connect to the network.

Ofgem also state “application of the ET requires the customer “deemed” to have triggered the investment to make an upfront payment to meet the financial shortfall [of transportation revenue from the connection over the lifespan of the asset not meeting the financial cost incurred in providing it], but since customers already connected to the network have not made any long term commitment to use and pay for the 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”.

In response to the above comment by Ofgem, it appears to us that Ofgem is confusing the application of the ET with a user commitment requirement. In any event, we should point out that customers that are already connected to the network may well have made a contribution towards the cost of the existing capacity, either pre-1998 under the deep connection policy or post-1998 under the shallow connection policy and the application of the ET. Therefore, the last customer is being treated in exactly the same way as existing customers were treated when they were new. Furthermore, the ET is not about user commitment *per se*. It is about protecting the generality of consumers against greater than average reinforcement costs being triggered by a particular new connection. That said, we would argue that a customer is unlikely to commit to providing an upfront contribution to a connection if it is in any doubt of its intention/ability to remain connected to the network and incur the associated on going charges.

Ofgem has also suggested that an up front contribution should only be required where it can be demonstrated that the customer in question has a higher risk than existing customers of not using capacity. Again, this is about user commitment and is not concerned with the rationale of applying the ET. That said, there is a user commitment framework to address Ofgem’s concerns in this respect, this is the requirement for certain loads to enter into an advanced reservation of capacity agreement (ARCA).

Ofgem concludes its discussion on the application of the ET in paragraph 18 of your letter. In this paragraph Ofgem makes two distinctive points.

- First it states that “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”.
- Second, “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”.

Taking each of the above points in turn. The current application of the ET only results in a capital contribution being made up front where the customer in question triggers higher than average system reinforcement costs – i.e. where the costs of the reinforcement upstream of the connection charging point are greater than the revenue the network will receive over the lifetime of those additional assets required to support the new load. Furthermore, it is important to remember that as part of our overall economic assessment of a new connection that has triggered reinforcement, we establish the effect the load has on the system with no other loads connected. In other words, the new load is assessed independently of any other load already connected to the system. In this way, we are firmly of the view that where the ET determines that a contribution is required, it is demonstrable that the contribution is justified since this connection imposes greater than average specific reinforcement requirements and is not unduly discriminatory. We should also add that every load has been/is treated in exactly the same way and therefore there is no possible claim of discriminatory behaviour.

In response to Ofgem's second point, as we have already indicated, this is an issue that relates to user commitment and not the ET. We have already explained that the ARCA framework is in place to provide an element of user commitment where the regime dictates that this is necessary.

Price control implications

Having considered all of the above points of discussion, it appears to us that Ofgem has a number of concerns with the current regime but it is not immediately clear what Ofgem's ultimate aim is. On the one hand, it appears that Ofgem is criticising the lack of cost reflectivity associated with a shallow connections policy (which could be construed as advocating a move to a deeper policy). Yet at the same time, Ofgem is criticising the GDN's application of the ET that seeks to protect some of the "shortfalls" of a shallow connections policy (advocating an even "shallower" policy).

However, irrespective of what Ofgem's ultimate aim is in this respect, the existing GDN transportation charging and connections regime are based on a shallow connections policy with the application of the ET along with a postalised transportation charging methodology. These models have either been directed, approved and/or endorsed by Ofgem, the most recent of which being the basis upon which Ofgem has set the 2008 – 2013 gas distribution price control.

If, as it would seem, Ofgem is now questioning this regime and suggesting that either there should be a move to a more cost reflective approach to transportation charges (i.e site specific transportation charges) or a move to a fully shallow policy with the removal of the ET (and the application of a more aggressive user commitment policy) there will be significant price control implications. The former would result in additional system and administration costs to the GDNs whilst the latter would result in a capex funding shortfall for the GDNs. It would therefore be totally unacceptable for us to operate under a regime that differs to that upon which the price control has been based.

Conclusion

To conclude therefore:

1. We agree with Ofgem that it is not appropriate to apply the ET to legacy interruptible customers becoming firm as of 1st October 2011 as a result of the regime change.
2. We do not agree with Ofgem that it is discriminatory to continue to apply the ET to new customers wishing to connect to the network beyond 2011 whilst not applying it to existing interruptible customers becoming firm at a specific point in time as a result of a regime change.
3. We do not agree with Ofgem that the current application of the ET is unduly discriminatory.
4. We are unsure what Ofgem's intention is going forward. In particular, whether Ofgem is advocating a move to more cost reflective transportation charges which suggests a move away from the current shallow connections policy; or the removal of the ET which suggests a fully shallow connections policy.
5. Irrespective of what Ofgem's intention is, a move away from the policies upon which the 2008 – 2013 price control has been set within that period would be unacceptable.

I hope that you find the above discussion useful and we look forward to engaging with you further on this matter.

Yours sincerely

Rob McDonald
Director of Regulation