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Dear John

Comments on Ofgem's Draft Impact Assessment on DNPC03 – LDZ System Charges Capacity Commodity Split and Interruptible Discounts

Ofgem has asked for comments on the above Draft Impact Assessment. Overall, Scotia Gas Networks (SGN) welcomes Ofgem's view that:

- The benefits of the proposal in terms of more efficient use of network assets and more stable distribution charges outweigh the costs; and that
- The distributional effects are likely to be small.

Turning now to the specific questions that Ofgem has asked.

Chapter 2. Key Issues

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

SGN agree with the assessment of the proposal against objectives of the distribution charging methodology.

While Ofgem believes that the approach can not be purely justified on cost reflectivity we believe that it can be *largely* justified against this criterion. We also agree with Ofgem that there are substantial additional benefits from de-coupling collected revenue and system throughput.

We agree that the proposal is consistent with the requirement to take account of changes in the transportation business in that it better aligns it with the regulatory framework. By proposing a reduction in the level of collected revenue subject to throughput related variation the Gas Distribution Networks (GDNs) are not only removing an apparent discrepancy in the regulatory regime but also facilitating the objective of stability in the level of distribution charges.

Finally, we agree with Ofgem's assessment that the expected reduction in charge volatility would, in our view, be beneficial to competition in general.

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

SGN's view on the elements of Use of System costs and what they relate to are those set out in DNPC03, we have not therefore repeated them here.

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

As we have indicated above, while Ofgem has suggested that the adoption of the proposed change to the charging methodology can not be justified purely on the basis of cost reflectivity, SGN considers that the approach referred to can be justified, if not purely, then very largely on the basis of cost reflectivity.

We note that Ofgem has stated that the cost data submitted by the GDNs does not support the assertion, on which the proposal is based, that 95% of the Use of System (UoS) costs are directly related to capacity. For clarity, DNPC03 did not say that 95% of the UoS costs are directly related to capacity. Rather, that the analysis showed that for all the GDNs only a small proportion of the costs reflected in the LDZ system charges, on average about 5%, are related to throughput (commodity), and the rest are capacity related costs or fixed overheads which are more appropriately recovered through capacity charges. It further explained that of the 32% indirect costs, none are throughput related.

In other words, the GDNs recognised that an element of the costs were not throughput related and therefore considered that it would be more appropriate to recover these costs through capacity charges. In fact many overhead costs can be shown to be related to capacity. For example formula rates are related to the asset value of the business which is more related to capacity than commodity. Also a substantial proportion of the other indirect costs, for example HR, Finance, and IT, are to support the direct activities, and virtually all of these activities are related to capacity. The main throughput related cost is shrinkage, which requires minimal overhead support.

We note that Ofgem has suggested that the use of an equi-proportional mark-up of the fixed costs may be more appropriate to the proposed methodology that allocates all of these costs to capacity. If this approach were to be adopted, the resulting charge split would be very similar to that proposed and, in our view, not significantly different to the current proposal. We therefore agree with Ofgem's view provided in paragraph 2.11 and 2.12 that it would be inappropriate to recover fixed costs through a commodity based charge and we welcome Ofgem's recognition that the recovery of these fixed costs might be best achieved through increased capacity charges.

Although in principle it might be more correct to do the analysis on a marginal cost rather than an average cost basis it has always proved impractical in gas distribution to determine marginal costs with any degree of accuracy. We therefore believe that in practice it is more reliable to adopt an average cost basis as in the proposed methodology.

Chapter 3. Distributional Impacts

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

SGN are in agreement with the methodology used to determine the distributional impacts of the proposal. However we have the following comments.

Table 3.1 - It should be noted that the adjustment factors which will be used if the proposal goes ahead for implementation will be different from the ones shown in the table 3.1. This is because various factors which affect charges such as customer numbers, load factors, AQs and SOQs will change between the time when the Impact Assessment was produced and implementation of the proposal.

Table 3.2 – It is not clear what parts of the country the three Regions shown include.

Tables 3.3 - 3.7 – The text following the tables on distributional effects should make it clear that the percentage changes and financial figures are indicative only, and the actual effects on supply points if and when the proposal is implemented will be different.

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

SGN cannot identify any additional distributional impacts.

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

SGN are in agreement with the transitional methodology to be applied to interruptible supply points.

4. Other Impacts

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

SGN accept the views presented in the impact assessment. That is, while small businesses will see a small rise in their charges, the effect would not be material; any impact on security of supply is likely to be positive; and, since gas transportation charges are regarded as only having a slight effect on annual consumption, this change is unlikely to have an impact on energy efficiency.

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

SGN do not have any additional information.

5. Unintended Consequences

Question 1: *Can respondents identify additional significant unintended consequences?*

SGN do not have any additional information.

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

SGN regrets the deferment of the decision on whether or not to proceed with a statutory consultation to amend the Licence until a view has been reached on the capacity commodity split. This is because the ability of the GDNs to change charges in April as well as October would help to reduce the volatility of their charges.

6. Cost Benefit Analysis

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

To the best of our knowledge SGN agree that all relevant costs and benefits have been identified.

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 IA.*

SGN is surprised that none of the respondents regarded greater stability of charges as delivering any significant benefits when this always seemed to be something shippers were very keen on. Many shippers have said that predictability is as, if not more, important than stability, and it should be stressed that greater stability will mean greater predictability.

We hope that you will find these comments useful.

Yours sincerely

Victoria Hunter
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