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11th June 2012

Dear Joanna,

Re: Mitigating network charging volatility arising from the price control settlement consultation (52/12)

We welcome the opportunity to provide a response to this consultation. This response is provided on behalf of National Grid Gas plc (NGG) in its role as owner and operator of four gas distribution networks in Great Britain.

In the main body of this response we present general observations on the subject of network charging volatility, following our engagement with stakeholders, and our high level views on the options presented in the consultation. A full response to the questions raised in the consultation is provided in Annex 1.

General Views

Whilst we agree with Ofgem that predictability of charges is important in respect of charging volatility, our RIIO-GD1 stakeholder engagement and discussions at the Gas Distribution Charging Forum have highlighted that different shippers and consumers have diverse views on the relative importance of stability and predictability depending upon their particular circumstances and market segment. Any proposed solution should thus be considered against how it will meet the desires of stakeholders with differing views.

Since the issue is about improving stakeholder satisfaction with charges it would seem appropriate to include this within the new RIIO Stakeholder Incentive so that Network Operators (NWOs) can determine how best to satisfy stakeholders and, where an improved service is provided, be rewarded. Given this overall aim, we consider that NWOs should be given greater freedom to determine the means of providing better services for their stakeholders. In our RIIO-GD1 business plan, we have proposed that some of the regulations relating to charge setting within the licence be loosened so that we have the freedom to improve such services. It is worth noting that this is an area where stakeholder and shareholder satisfaction, through stable charging and revenue profiling across years, should be aligned to the benefit of both.

In this context, we consider that Ofgem's proposals may be over-prescriptive in determining how NWOs should set their charges to best manage charging volatility. This is not just because we consider that the NWO is best placed to determine such matters, but also because, as we highlight further on, there are factors other than annual allowed revenue levels which impact on the volatility of the charges which customers face and which need to be taken into account at the time of setting charges. In short, we consider that, whilst there are aspects of the price control design that can be beneficially changed to improve charging volatility, this is an area where, overall, less regulation may be better regulation.

For example, over the period of the current gas distribution price control many of the charging volatility issues highlighted by stakeholders have related, either directly or indirectly, to the current tight licence restrictions on charge-setting. This can be illustrated by the penal interest rates for over- or under-recovery beyond tight limits, the restrictions potentially imposed by significantly over-recovering in a single year or consecutively over two years, and the bar on deliberately over-recovering. These licence conditions have restricted or deterred us from implementing less volatile charges to the detriment of our customers. Whilst the licence conditions were no doubt set with the best of intentions, their interaction with the uncertainties and variations in other factors impacting on the level of charges has led to greater charging volatility over the period than there would otherwise have been.

We agree that changes to the actual methodologies should sit outside the scope of this consultation. However, the application of an unchanged methodology from year to year can still give changes to NWO charges by customer group which vary from the average level, due to changes in the factors impacting on the derivation of actual charges. It is the particular variation to the charges faced by a customer which impacts their perception of volatility not just the average change.

Similarly, changes to the revenue charging base, such as that determined from the annual industry review of supply point capacity, can be a major contributor to the uncertainty around future charge levels and also to the volatility in actual charge levels experienced from year to year. Given that such changes are largely outside of the control of the NWO, their impact needs to be taken into account in any proposals to better manage volatility.

Ofgem has developed five potential options and has helpfully provided an initial assessment of these options. As already noted, we do not consider that these options cover all the ways of better managing charging volatility. In addition, we consider that there are other criteria that need to be included in assessing these and other options. An example of which is that, even where the time-value of cash is kept whole, the lagging of allowances and collected revenues has negative impacts on the cost-reflectivity of the resultant charges and also on the earnings profile for NWOs, which can increase NWO finance costs. These impacts need to be taken into consideration alongside any predictability benefits in assessing the options in order to achieve a balanced outcome for all parties.

Summary of our views on Ofgem options

Option 1

NGG agrees that better information provision can help improve the predictability of charges to some extent and helps to improve the understanding of the uncertainties around charge levels. Over the current price control period we have improved the level of information that is provided and continue to engage with stakeholders on this. We agree this should be done in combination with other changes to improve charging volatility.

Option 2

We consider that restricting the frequency of intra-year charge changes can help to improve the stability of charges but needs to be aligned with other changes, and in particular changes to the licence restrictions around charge setting, to achieve this benefit. With the recent introduction of the pass through of some transmission-related costs through the gas distribution network charges, it is important that such restrictions, and their timing aspects, are aligned across gas transmission and distribution networks as far as practicable.

Option3

We consider that increasing the lag on adjustments to allowed revenue due to incentive rewards or penalties may for certain incentives be useful, if combined with the changes discussed for Option 2, so that greater stability and predictability of charges can be provided. Implementation of this option alone will help with the predictability of allowed revenue but will not help at all with the stability of charges since it will just move the pattern of charge changes across years. We consider that the impacts on NWO earnings profiles and financability and on the cost-reflectivity of the resultant charges need to be taken into account in considering where such lagging may be appropriate.

Option 4

We agree with Ofgem's assessment that further delaying the timing of adjustments to allowed revenues due to the provision of uncertainty mechanisms is unlikely to be beneficial.

Option 5

We agree with Ofgem's assessment that implementation of a cap and collar on allowed revenue changes is unlikely to be of benefit to industry or the end consumer, in causing increased financing and cash flow risk for only limited benefit to other industry participants.

In relation to Appendix Four, we have no comments or complaints to make against how this consultation has been conducted.

If you would like to discuss any aspect of this response please contact Steve Armstrong on 07770 703101 or at steve.armstrong@nationalgrid.com.

Yours sincerely

[By e-mail]

Paul Rogers
Regulatory Frameworks Manager

Annex 1 – National Grid Gas Distribution Detailed Responses to Questions Raised in Consultation

Chapter 2 – Network Charging Volatility

Question 2.1: Have we correctly characterised the scope of the problems we are trying to address?

Whilst we agree with Ofgem that predictability of charges is important in respect of charging volatility, our RIIO-GD1 stakeholder engagement and discussions at the Gas Distribution Charging Forum have highlighted that different shippers and consumers have views on the relative importance of stability and predictability depending upon their particular circumstances and market segment. Any proposed solution should thus be considered against how it will meet the desires of stakeholders with differing views.

Question 2.2: Are there certain market segments or groups of customers that are particularly affected by charging volatility?

Our stakeholder engagement shows that customers perceive charging volatility issues in different ways. For example, whilst some domestic shippers might focus on predictability of charges, in part to help with their fixed price supply options, some non-domestic shippers place emphasis on both predictability and stability. Furthermore, some gas consumers with transportation cost pass-through contracts find the variability in transportation costs an issue, both for its effect on the overall supply price and in terms of their ability to check suppliers' prices. Such variability could thus be considered to have a potential negative impact on supply competition for this sector.

Question 2.3: Do you agree with the assessment criteria? Are there additional criteria that we should adopt for our final assessment?

We agree that the assessment criteria identified are appropriate in part but consider that, as described, they are incomplete. For example, we agree that risk sharing should be a key criterion with the impact of the temporal movement of revenues on cash-flow risk and financing costs mentioned, however such changes also impact on NWOs' earnings profiles, which needs to be taken into consideration.

We agree that complexity is a relevant criterion since our stakeholder engagement has indicated that users value charges which are transparent and predictable. However, it is not just the complexity of setting allowed revenues which needs to be taken into account in terms of the impact on transparency and predictability. Other factors such as the timing and periodicity of charges, inputs into the methodology impacting on the allocation of revenue by customer groups, and changes to the charging bases (e.g. capacity determination) impact on the charge rates which customers face. The impact of proposed options on the complexity of the overall determination of the final charge rates needs to be considered. We are concerned that some of the options not only introduce additional complexity into the revenue calculation but could, in practice, interact with the wider factors impacting on charge rates in an unforeseen manner so as to fail to deliver any worthwhile improvement in charging volatility.

An additional criterion that we consider should be included in assessing options is the impact on the cost reflectivity of the resulting charges, since cost reflectivity is, for gas distribution, the prime charging methodology objective in most situations. For example, delaying the recovery of incentive revenues can help with the predictability of allowed revenues but can mean that the applied charges impact a slightly different stakeholder base (both gas shippers and end consumers) from those initially impacted by the incentive performance. Delays to such revenue collection also distort the overall linkage between the level of charges and network performance for a given period so negatively impacting on cost reflectivity.

Chapter 3 – Options to mitigate volatility in network charges

Question 3.1: Do you have any further suggestions of what could be done to mitigate network charging volatility arising from the price control settlement?

All of the outlined options (other than Option 1) assume that the targeted revenue when setting charges is aligned with the price control maximum allowed revenue for the year and therefore that the only means of reducing volatility is to control the annual allowed revenue in a better way. We consider that this is a limited and erroneous view since:

- As already noted, there are factors other than allowed revenue which impact on the particular level of charges faced by any customer. We consider it likely that the uncertainties and variations in these factors would lead to some charging volatility under any of the options proposed and for some options this could happen in unpredictable ways.
- The requirement to align targeted charge revenue with allowed revenue on an annual basis is imposed by licence conditions which (for gas distribution) place restrictions on charge setting and incentives (both financial and regulatory) on avoiding any substantial difference between the level of revenue actually collected in a year and that allowed. We consider that the current licence conditions have been a major factor in the level of charging volatility experienced over the current price control period.
- Factors other than allowed revenue impact on the charges. Since the uncertainties around these factors only gets resolved around the time of any particular charging period, it is better to enable NWOs to deliver improved charging volatility through actions taken closer to the time of the charging periods than to set prescriptive measures prior to an 8 year period.
- Fundamentally, delivering improved stakeholder satisfaction on charging volatility extends beyond the control of allowed revenues and is an objective which NWOs should be given the freedom to deliver. This is an area where reduced regulation rather than further regulation would better deliver the objective.

We suggest that an alternative means of mitigating charging volatility is to make the delivery of improved volatility part of the network's Stakeholder Incentive subject to appropriate loosening of the existing restrictions on charge setting so as to enable the NWOs to have the freedom to determine how best to satisfy customers in this respect. We consider that this is an area where stakeholder and shareholder satisfaction, through stable charging and revenue profiling across years, should be aligned to the benefit of both.

In our April RIIO-GD1 Business Plan we set out the potential changes to the licence constraints which would be beneficial under this option and showed how it could lead to a significantly more stable pattern of charges over the RIIO-GD1 period than otherwise.

In addition for any option, it is important to consider the external factors which impact on charging volatility such as, for gas distribution, the redetermination of capacity by shippers mid-way through the charging year. This increases the uncertainty of revenue collection and thus makes future charge levels less stable. NGG raised a UNC proposal to stabilise this aspect of charging for each revenue year with the aim of improving charge stability. Discussion of this change is ongoing through Project Nexus development.

Question 3.2: Do you agree with our initial assessment of each option?

NGG agrees that Option 1, better information provision, could help improve the predictability of charges to some extent and help to improve the understanding of the uncertainties around charge levels. We agree this should be done in combination with other changes to improve charging volatility.

During this price control period we have engaged with shippers, seeking their views on the information they would like to see, and as a consequence have improved the quarterly revenue reports produced. This has been done through common NWO discussions with shippers without the need for formal change processes. Positive feedback has been received from those attending the meetings at which the reports are presented. We are continuing to seek views on further improvements to the reports to help users to understand and predict the likely changes to charges and the uncertainties around this.

We consider that Option 2, restricting the frequency of intra-year charge changes, could help to improve the stability of charges but needs to be aligned with other changes to achieve this benefit. Unless the uncertainties in all major factors impacting on both the allowed and collected revenue can be eliminated we consider that such a restriction should only be on a “reasonable endeavours” basis.

For gas distribution, our licence already requires us to endeavour to only amend charges once per year at April. However, the form of the current price control, with significant uncertainties around the level of allowed revenue which are not fully resolved until the end of the charging year, and the current licence constraints on charge setting mean that such stability is not achieved at present. The current licence conditions prohibit deliberately over-recovering for a year and impose financial and regulatory penalties on over or under-recovery beyond tight limits. We consider that, in order for this option to help improve the stability of charges, these limits should be eliminated or significantly increased so that the NWOs have greater flexibility to deliver charging stability. In addition, it is necessary for the time value of revenue which is delayed or brought forward to be protected in line with the WACC and RPI.

We consider that Option 3, increasing the lag on adjustments to allowed revenue due to incentive rewards or penalties, may for certain incentives be useful, if combined with the changes discussed for Option 2, so that greater stability and predictability of charges can be provided. Implementation of this option alone will help with the predictability of allowed revenue but will not help at all with the stability of charges – it will just move the pattern of charge changes across years. Under this option, even if the cash value of revenues across time is protected, there will be undesirable potential impacts on NWOs’ earnings which are not fully considered in the assessment.

It appears that where there is uncertainty around a revenue adjustment item then lagging the whole adjustment is the only option considered. This can have significant impacts on NWOs’ earnings and results in revenues being delinked in time to cost causations so that the cost reflectivity of charges is weakened. Ofgem have recognised the undesirability of a complete lag for the impact of RPI and have proposed a mechanism whereby the forecast impact of RPI is incorporated in advance of the charging year and only the reconciliation of the difference between the actual and forecast impact of RPI is accounted for through the lagging mechanism. We consider that similar approaches should be included for any incentive or cost pass-through adjustment of any significant size rather than lagging the whole impact. Such RPI-type adjustments will still provide the certainty required in advance whilst enabling subsequent reconciliation.

We agree that Option 4, increasing the lag on adjustments to allowed revenues due to the provision of uncertainty mechanisms, would not improve the allocation of risk. The timing of uncertainty mechanisms will be known in advance, as will the intention of the NWO to apply for such an adjustment, therefore delaying the adjustment for such a mechanism will not significantly improve the forecastability of charges and could lead to significant financing issues for the NWOs since it is proposed by Ofgem that such uncertainty mechanisms will only operate where the revenue adjustment is beyond a set limit. In addition, such lags would lead to increased variation between the timing of the initial impacts leading to the cost increases and the collection of revenues so reducing even further the cost reflectivity of the resulting charges.

We consider that Option 5, imposing a cap and collar on changes to allowed revenues, is unlikely to improve charging stability and may well have the opposite effect. Analysis undertaken and discussed at the gas Distribution Charging Methodology Forum of such proposals showed that such restrictions could in some realistic instances lead to large delays in the NWOs' collection of revenues, impacting on their earnings, and ultimately lead to the need for the recovery of large amounts of uncollected revenue at a future time which is likely to produce significant volatility in charges levels then. Such instances could occur due to external factors such as the impact of gas wholesale prices on the value of gas shrinkage or changes to capacity levels, over which the NWO has no control. We consider it is better to tackle the underlying issues impacting on charging volatility rather than to impose arbitrary restrictions on the allowed revenue which may well exacerbate the problem.

Specific questions in relation to option 1:

Question 3.3: Do code and licence charge notification differences in each network sector create problems in managing charge changes?

In general this is more relevant to our stakeholders. However, this is an issue for us in relation to the pass-through of NTS offtake costs through the Distribution Network operators (DN) transportation charges. At present we endeavour to only change our DN transportation charges, including (from 2013 onwards) those reflecting the NTS offtake costs, in April of each year whereas the NTS exit charges are normally changed in October. This discrepancy in charging periods results in us needing to forecast NTS offtake charges, which can be quite volatile, both in level and by offtake, for half of the DN charging period, so introducing significant uncertainty in the level of costs to be passed through when setting charges. This will then impact future charge levels so reducing the cost reflectivity of this aspect of the charges. We consider that there could be benefit from aligning the Gas Transmission licence requirements with those for DNs so as to produce a more predictable and transparent pass-through of costs. If such alignment is achieved it will still be beneficial for the notification periods for Gas Transmission to be slightly earlier than those for DNs to enable the processing of the Gas Transmission charge information to determine the DN transportation charges by the required time.

Question 3.4: What information would you like the network operators to provide, that they currently do not, in order to help improve predictability of network charges for different customer groups? This should include:
a) what information you would like to see in their business plan submissions, and
b) what information you would like to see provided on an ongoing basis.

NGG has engaged extensively with stakeholders as part of our RIIO-GD1 price control process to understand and incorporate, where possible accounting for commercial confidentiality, information customers would like to see in our business plan submissions. We would welcome any further engagement and suggestions from our stakeholders that we can take into account in the future.

Through the gas Distribution Charging Methodology Forum we have engaged with stakeholders on the level of information they would like to see within the quarterly revenue reports which we publish which focus on revenue and charge forecasts for the next five years. During the period of the present price control we have responded to stakeholders' desires for greater granularity of information in these reports without the need for formal changes to their specification and have received positive feedback from them.

However, the usefulness of information to shippers in helping to improve the predictability of charges needs to be considered since the unstructured provision of information can lead to confusion around the predictability of the charges.

Question 3.5: What information do you think we could provide, that the network operators cannot, that would benefit you in terms of improving predictability of network charges?

We consider that provision of the RIIO financial model could provide a useful tool to enable stakeholders to better understand the reasons for gas distribution revenue changes. Making the RIIO financial model available to all parties would provide greater transparency on the reasons for revenue changes. In gas distribution, when transportation charges are updated such information is already provided as to the causes and this would seem a natural extension to this process.

Specific questions in relation to option 2:

Question 3.6: In the last five years how frequently have networks introduced intra-year changes? What were the main reasons for these changes?

NGG has introduced intra-year changes twice in the last five years, at October 2009 (for London and West Midlands DNs) and October 2010 (for West Midlands DN). In both cases charges were reduced mid-year in order to avoid potentially significant over-recovery for the year as a whole and the resulting licence implications in terms of the penal interest rate applied to over-recovery of over 3% and licence restrictions on future charge-setting for over-recovery of 4% and potential cumulative over-recovery of 6%. We consider that these are examples of situations where the current licence conditions, in combination with factors impacting upon the revenue, have led to greater charging volatility than would otherwise have occurred.

For October 2009, the forecast significant over-recovery was related to three main factors: gas wholesale prices reducing substantially (by around 40%) after the April charges were set, so reducing the shrinkage cost allowance element within the maximum allowed revenue;

the forecast level of capacity changes at October 2009 which, for West Midlands, were expected to be smaller than previously estimated, so increasing anticipated collected revenue; and changes to the expected level of mains and services replacement work undertaken in London, relating to the differences between the HSE and licence definitions of London network (the Outer Met area), impacting on the forecast maximum allowed revenue.

For October 2010, the forecast over-recovery was related to a smaller under-recovery in the previous year which then reduced the maximum allowed revenue for 2010/11 and to a reduction in the forecast level of mains and services replacement work for the year which also reduced the expected maximum allowed revenue.

In both cases the decisions were taken with there still being a significant level of uncertainty around the allowed and collected revenue levels for the relevant year. Two month's notice of the change was provided in each case.

Question 3.7: Are there any business processes that would mean only allowing one change per year on 1 April would not be feasible?

NGG currently works on the basis of expecting to make only one change to charges per year, on 1 April. This requires us to forecast the impact of external factors such as the gas wholesale price on the shrinkage element of the maximum allowed revenue. We also need to forecast the level of the charging base, principally supply point capacity, throughout the charging period knowing that a significant and uncertain change at 1 October is to be expected. Unless the uncertainties in all major factors impacting on both the allowed and collected revenue can be eliminated we consider that a restriction to one change per year should only be on a "reasonable endeavours" basis.

In addition, since a significant element of the gas distribution allowed revenue is the pass-through of NTS offtake capacity costs, it would be highly beneficial to align the timing of any such single change per year across the gas distribution and transmission NWOs and for the notice period for transmission charges to be longer than for distribution charges to allow time for the transmission information to be used in determining the distribution charges.

Question 3.8: Do you think that there should be exemptions that would allow for changes due to specific events? Do you think these events should include the occurrence of errors when calculating charges or changes to the charging methodologies? Are there any other events that should potentially be exempt?

NGG believes it may be pragmatic, mainly from a process perspective, to include exemptions to the restriction on frequency of changes to provide flexibility in limited, defined circumstances and / or with the approval of the Authority. To the extent that the wider commercial framework does not allow for errors to be corrected, it would be appropriate to include changes due to errors to ensure that these are rectified as quickly as possible. In addition to the exclusions included in the consultation, it may be appropriate to also include provisions for:

- Wider regulatory changes or framework changes, other than the charging methodology itself, that could impact the cash flows of NWOs. Such impacts might arise when changes are made to network access arrangements, which sit outside the charging methodology;
- Directions made by the Secretary of State related to special administration arrangements and security of supply provisions.

Question 3.9: Do you agree with our proposed change to the penalty for over or under recoveries were this option to be implemented?

Were Option 2 to be implemented then NGG considers that it would be appropriate to relax the penalties for over or under recoveries with these changes, possibly taking into account the specific circumstances of each licensee and form of control. Further, we consider that under this option all the licence conditions relating to the setting of charges, such as the regulatory disincentive to over-recover beyond a limit in a single year or cumulatively over two years, should be relaxed so as to provide greater freedom to NWOs to deliver less volatile charges across years.

We consider that the experience in gas distribution over the current price control period provides evidence that the current licence conditions in this regard have, in combination with other factors, worked to the detriment of stakeholders in leading to more volatile charges than would otherwise have occurred.

As we suggest in the alternative option which we propose, we consider that better charging stability could be delivered if the licence restrictions around charge setting were considerably relaxed so that the NWO could reasonably be incentivised to deliver less charging volatility.

In our April RIIO-GD1 Business Plan we have suggested that potential changes to the licence restrictions could be:

- Widening the 3% K bands where penal interest rates apply, to 10%;
- Widening the 4% over-recovery limit, to 10%, beyond which we would lose some control over future charge levels;
- Allowing us to deliberately over-recover against allowed revenue in a year where we can show that such action would be expected to lead to greater charge level stability than otherwise, and possibly consulting with the industry prior to any such action.

Question 3.10: Do you agree with our initial view that there should be a two year lag on adjustments due to the over or under recovery of revenue through the correction factor?

Lagging over or under recovery adjustments by two years should help with the predictability of allowed revenue but will not help with the stability of charges since it merely moves the variation from one time period to another. A two year delay to such adjustments will also lead to greater discrepancy between the timing of the incursion of costs and the recovery of related revenues, so reducing the cost-reflectivity of the charging regime, and will impact negatively on the NWO earnings profile.

We consider that it could be better for the NWO to incorporate the forecast level of end of year over or under adjustment into the target level of revenue when setting charges for the following year, with the forecast used fixed several months in advance of the charging period so as to provide a balance between predictability of charges and timely collection of allowed revenues. The reconciliation between the forecast adjustment incorporated and the actual end of year adjustment could then be incorporated into the allowed revenue with a two year lag. In this manner the adjustment would operate in a similar manner to that proposed by Ofgem for handling RPI.

Question 3.11: Are you aware of any errors that have been made when calculating network charges in sectors other than electricity distribution?

We are not aware of any errors within the current price control period in calculating the transportation charges for NGG's distribution networks. We consider that the issue of error handling is distinct from the general issue of charging volatility.

Question 3.12: Do you think that introducing an additional licence condition to penalise NWOs when they make charge calculation errors is warranted?

NGG believes the case for introducing a new licence condition to penalise for network companies when they make charge calculation errors is entirely unwarranted, particularly given the lack of evidence that this is a problem for gas distribution charging. Any penalties relating to the accuracy of NWO charges should only be considered in the context of highlighted issues for a particular sector and Ofgem consultation on this particular issue, which we consider is distinct from charging volatility. Such a proposal for a solution to a problem that doesn't exist is a clear contravention of better regulation principles.

Specific questions in relation to option 3:

Question 3.13: What do you consider to be an appropriate notice period for changes to allowed revenues?

We consider that the treatment of allowed revenues needs to take into account the magnitude of the allowance or adjustment, the level of uncertainty around the adjustment, and whether it relates to a matching cost exposure to the NWO.

We agree that delays to incentive adjustments can help with the predictability of allowed revenue. However such delays may have a disbenefit in terms of creating financability issues for the NWO (even assuming that the time-value of cash is fully protected), reducing the cost-reflectivity of charges, and creating extra complexity which reduces the transparency of charges.

For incentive adjustments of relatively small magnitude with a high level of uncertainty, such as discretionary awards, it may be appropriate to apply a two year lag since in these cases the benefits of predictability may outweigh the disbenefits. However, for adjustments of larger magnitude, which are relatively certain or which create financing issues within the year of the incentive, the noted disbenefits are likely to outweigh any predictability benefits. In these cases it may be appropriate to pass-through the adjustment within the year or else apply a forecast adjustment within the incentive year with a two year lag applied to the reconciliation between the forecast and actual adjustment.

For example, under the current gas distribution price control the volume of gas for the shrinkage allowance is fixed within the price control which provides an incentive to reduce actual shrinkage volumes, however the gas price used to determine the value of the allowance is not known until within the price control year. In this instance we consider that it would be appropriate to allow pass-through of the cost within the year since it is a significant charge element where the NWO must incur a similar level of costs within the year. For this type of incentive it could be appropriate to apply a forecast of the incentive value, fixed some months prior to the charging year, when determining the target revenue for setting charges, with subsequent reconciliation. However, it should be noted that gas shippers and suppliers are familiar with the uncertainties created by wholesale gas prices, and there are well established mechanisms for hedging these risks, and so it may be considered that in this instance the risk is best managed by the gas shipper or supplier.

Question 3.14: Do you consider there to be any potential exemptions to our proposal to lag all incentive adjustments?

As highlighted above, lagging of revenue adjustments has disbenefits which need to be balanced against the advantages of predictability. The option of using a forecast value for the initial revenue adjustment with the variation between the forecast and final outturn values handled through a lagged adjustment (as for RPI) should be considered in each case.

We consider that there are some forms of incentives, particularly output-based, where it is more appropriate to recover the incentive revenue within the relevant period, rather than lagging it. This is because the NWO may otherwise be incurring substantial costs to deliver the outputs without obtaining corresponding revenues in the same period, leading to a negative impact on earnings.

In addition, as noted above, for incentives which involve the wholesale value of gas it may be more appropriate to recover the incentive revenues without a lag as the impact of gas prices is incurred immediately. Whilst hedging gas price risk is possible, NWOs are not funded for and do not have the resources or core skills of shippers to manage such complex instruments.

Specific questions in relation to option 4:

Question 3.15: Do you agree or disagree with our initial assessment of whether a lag should be applied to the following uncertainty mechanisms? Please explain your reasoning.

We agree with Ofgem's assessment that it is not beneficial to automatically lag all revenue adjustments due to uncertainty mechanisms. Our comments on the particular types of mechanisms are shown below.

a) indexation

We agree that, since these annual changes are based on publicly available information and therefore predictable, lagging is not warranted.

b) pass through costs

NGG has a number of different costs that are subject to pass through. Generally these cost items can be predicted at the year ahead stage. However, there are times when externalities reduce the accuracy of these forecasts, for example, business rate revaluations that occur every five years and one-off regulatory / government costs that feed through to licence fees.

A significant cost pass through item introduced recently is the cost of procuring transmission offtake capacity. We consider that it is appropriate to pass through this cost within the year since it would otherwise create a large additional financing cost. If reliable forecasts of transmission charges are provided prior to the charging year then the gas distribution forecast of the offtake cost should be similarly accurate since it will be based primarily on bookings of offtake capacity made three years prior to the charging year.

c) revenue drivers

We consider that it is unlikely to be beneficial to lag adjustments arising from revenue drivers. Although the form of revenue drivers to apply within RIIO-GD1 is not yet known, it is expected that these will relate to trigger events which should have some external visibility and so should be reasonably predictable. It may be beneficial for the NWO to publish forecasts of the situation for trigger events prior to their triggering on an ongoing basis, as part of their quarterly revenue forecast, to help stakeholders to forecast and understand the likely charge impacts.

d) within period determinations

We agree that lagging would not be appropriate since it could create significant financability issues.

e) reopeners

Uncertainty mechanisms are used to provide NWOs with protection against the risk that additional costs may arise during a price control period that were not accounted for when setting allowed revenues due to a lack of certainty on the timing and/or the magnitude of such costs. Delaying the recovery of revenues relating to such mechanisms would go against the purpose of the within-price control period reopener. Such reopeners are subject to consultation and so should be relatively predictable to third parties. The RIIO-GD1 proposals already limit reopeners to two windows during price control period so NWOs will already have to cope with revenue recovery delay and it would not be appropriate to delay such revenue recovery further.

f) innovation funding

We agree that introducing a lag for such revenue adjustments would not be appropriate since the amounts are relatively small and the delays could reduce the incentive on the NWO to innovate.

Specific questions in relation to option 5:

Question 3.16: Do you agree or disagree with our initial assessment that the benefits of introducing one of the three options for a cap and collar do not outweigh the drawbacks?

We agree with Ofgem's initial assessment. We consider that imposing a cap and collar on changes to allowed revenues, is unlikely to improve charging stability and may well have the opposite effect. Analysis undertaken and discussed at the gas Distribution Charging Methodology Forum of such proposals showed that such restrictions could in some instances lead to large delays in the NWO's collection of revenues. This would have a negative impact on their earnings profile and financing costs, and ultimately lead to the need for the recovery of large amounts of uncollected revenue in future which is likely to produce significant volatility in charges levels. Such instances could occur due to external factors such as the impact of gas wholesale prices on the value of gas shrinkage or changes to capacity levels, over which the NWO has no control. We consider it is better to tackle the underlying issues impacting on charging volatility rather than to impose arbitrary restrictions on the allowed revenue which may well exacerbate the problem.

Question 3.17: Do you consider there are any other options for the design of a cap and collar mechanism that we have not considered?

We do not consider there are any other options for a cap and collar mechanism that would be worth considering.

Question 3.18: Do you have any views on whether a cap and collar, if implemented, should be symmetric or asymmetric?

We do not consider that any cap and collar scheme should be implemented. The detail of whether any such scheme should be symmetric or asymmetric would depend on the wider design of the scheme and how it interacted with other constraints on allowed revenue or charge setting.

Timing of implementation

Question 3.19: Do you agree that if changes are needed in the gas distribution or transmission sectors that they should be implemented on 1 April 2013, the start of the next price control period?

April 2013 may be a suitable implementation date for gas distribution subject to an appropriate prior notice period, depending upon the arrangements to be implemented.

Implementation timescales for any option which would have the potential to alter users' charges should be carefully considered to avoid any additional volatility to the network charge the option intends to assist.

Some of the options put forward may require further industry consultation and consideration prior to implementation, and it is vital that the duration of such a process is accounted for in the target implementation date.

Question 3.20: When should we apply any changes to the electricity distribution sector?

We have no view on this.