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Dear Joanna

Mitigating network charging volatility arising from the price control settlement

Thank you for the opportunity to comment on the above consultation.

Northern Gas Networks Limited (NGN) is supportive of the initiative to address the issues and problems associated with charging volatility and believe stable and predictable pricing structures are beneficial to shippers, consumers and Network Operators alike. Together with the other Gas Distribution Networks (GDNs), we have supported and engaged with shippers on charging volatility in both Uniform Network Code (UNC) workgroups and charging forums throughout the current GD-PCR1 price control, and now welcome the opportunity to formally address this issue with Ofgem.

We have given consideration to all of the suggested proposals within the consultation. We are broadly supportive of the proposals set out in options 1 to 3 and agree with Ofgem's reservations regarding options 4 and 5. We provide rationale for our support of the different options below, and provide answers to the specific questions set out in the consultation in the attached Appendix.

<u>Option 1 – Improved information provision</u>

NGN is highly supportive of improving the level of information provided in relation to GDN forecast revenue and price changes. The current quarterly GDN revenue forecasts, published in accordance with the UNC Mod 186, have worked well since introduction in October 2008 and NGN has a very credible record of accurately forecasting our actual price changes. In July 2011, all GDNs promptly agreed to requests from the shipper community to provide these forecasts in the format used by the Electricity Distribution Networks (EDNs), which included more detailed disclosures on the incentive/penalty adjustments and pass through cost adjustments to allowed revenue, together with a probability assessment of the impact of these items. NGN strongly believe providing a standard forecast revenue report across both the gas and electricity distribution sectors makes it easier for shippers and other relevant parties to understand the driving force behind revenue changes, which should in turn make charges more predictable for our shippers.

We are also supportive of publishing other key associated information that would be relevant to the interested parties. We are, however, concerned that publishing too detailed information could be misleading if not fully understood by the recipient. We therefore believe a concise but informative forecast revenue report, created after consultation with all interested parties, is the most suitable way of addressing charging volatility. If such a report is agreed upon and developed, we believe there is no reason why further reports or detail need to be disclosed.

Option 2 – Restricting the frequency of intra-year changes

NGN agree that restricting intra-year price changes improves predictability of price changes for shippers and throughout GD-PCR1 we have complied with our best endeavours requirement within the licence to implement just one price change each year. In 2009/10, however, NGN effected an intra-year price change as the fall in wholesale gas prices had a significant effect on our recovery of allowed revenue through the shrinkage incentive, and as a consequence we reduced our prices in October 2009 for the second half of the formula year. The reason this reduction was implemented was driven by NGN being bound by Special Conditions E2 in the licence, which imposes limits to the amounts by which GDNs may under/over recover allowed revenue in any formula year. We believe that relaxing these 'deadbands' and removing or separating the shrinkage gas allowance in K calculations would provide a workable solution to restricting intra-year changes.

In addition to the above, NGN consider it important for the timing of GDN and NTS price setting to be addressed and ideally harmonised. From October 2012, NTS Exit Capacity costs will be charged to the GDNs, who have in turn formulated a new 'ECN' charge to pass through this cost to the shippers. Under this process, if the NTS continue to implement price changes in October each year, at the time of price setting the GDNs will have to consider indicative NTS prices from the following October in generating the ECN charge effective from April. We believe this issue contributes significantly to charging volatility and predictability and therefore needs to be addressed as part of this consultation.

Option 3 – Increasing the lag on changes due to incentive rewards or penalties

NGN believe lagging adjustments to allowed revenue from certain incentive rewards/ penalties could also potentially improve predictability and consequently reduce any volatility risk. We consider the proposed lagging mechanism, whereby the reward/penalty for GDN performance in year t is reported in year t+1 and incorporated into our charges in year t+2 to be appropriate, as we believe this provides an optimum period to incentivise the GDNs and yet removes any uncertainty on charging that using forecast figures may create.

Of concern, however, is potential for the whole of the shrinkage incentive to be lagged by two years. In the current licence and RIIO licence drafts, the full shrinkage allowance is incorporated into the incentive mechanism. NGN believe only the incentivised element of shrinkage should be lagged and an allowance element be incorporated directly into allowed revenue within year. We believe the potential of a two year time lag between incurring the costs for shrinkage gas and recovering through revenue poses unduly unfair cash flow demands and that the GDNs should be reimbursed for this significant cost along the same timeframe in which it is incurred.

Option 4 – Increasing the lag on changes due to uncertainty mechanisms

NGN supports Ofgem's assessment that no lag should be provided for these mechanisms. The rationale for our support on each item is provided in our responses to the specific consultation questions in the attached Appendix.

Option 5 – Imposing a cap or collar on allowed revenue charges

NGN is averse to the proposals of imposing a cap/collar mechanism on allowed revenue charges. Whilst we believe this may give shippers a level of surety and predictability in the near term, this mechanism could easily place significant undue risk on GDN cash flows. Our obligations are in no way capped or collared and consequently we feel there is no justification for applying a similar mechanism to our allowed revenue. In addition, we have modelled the various scenarios suggested in this consultation using actual data from GD-PCR1 and have found, even with relatively generous caps and collars, that this leads to unacceptable logging up of under-recovered allowed revenue at the end of the price control, which would pose a significant cash flow risk to NGN. We are happy to disclose this analysis if requested.

If you have any queries on any aspect of this letter please do not hesitate to contact me.

Yours sincerely

Will Guest
Pricing Manager

APPENDIX – Responses to specific questions in the consultation

CHAPTER: Two

Question 2.1: Have we correctly characterised the scope of the problem we are trying to address?
Response: NGN believes the scope of the problem has been correctly characterised.

Question 2.2: Are there certain market segments or groups of customers that are particularly affected by charging volatility?
Response: NGN is fully aware that charging volatility is an industry-wide concern and affects consumers and shippers, as well as the GDNs. Within these groups of key stakeholders, the smaller parties tend to be burdened by a relatively higher level of risk and lack of resources and are therefore potentially more affected by charging volatility.

Question 2.3: Do you agree with the assessment criteria? Are there additional criteria that we should adopt for our final assessment?
Response: We agree with the assessment criteria and do not consider any additional criteria should be adopted in your final assessment.

CHAPTER: Three

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?
Response: In the NGN RIIO-GD1 Business Plan submissions we suggested consideration should be given to the timing and implementation date of the SOQ changes on network capacity charging. These changes, which currently become effective on 1 October each formula year, can have a significant impact on charging as any reduction in the capacity of the network requires an increase in transportation charges to ensure the GDNs receive their allowed revenues. Currently, forecast SOQ changes at October each year are built into the pricing calculations from the preceding April, at which point no provisional data or indicative capacity changes have actually been received by the GDNs. If the SOQ changes were still disclosed in October each year but not implemented until April the following year, the GDNs would be able to incorporate actual capacity changes into the pricing consultations and therefore eliminate the significant risk currently associated within under or over-estimating the magnitude of the change. NGN also believes that dissociating the requirement of SOQs for planning purposes from those involved in the pricing process could be a credible solution, and is currently exploring this option as part of the current industry-wide Project Nexus.

Question 3.2: Do you agree with our initial assessment of each option?
Response: NGN broadly agrees with the assessment of each option.

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?
Response: There are inconsistencies in both the current licence and UNC relating to GDN and Transmission price setting which should be addressed as part of this consultation. Even if price changes for both GDNs and the NTS were harmonised, it is imperative that the GDNs be provided with sufficient notice of NTS Exit Capacity charges to enable the calculation of an accurate and predictable ECN charge to shippers. We consider one calendar month as sufficient notice for the GDNs to be informed of NTS charges.

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.

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?

Response to Questions 3.4 and 3.5: We believe these questions are aimed towards the shipper community and therefore do not think it appropriate for us to comment on these questions.

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?
Response: In the last five years NGN has introduced an intra-year price change on just one occasion. This occurred in October 2009 when NGN reduced prices by 5% following a 3.6% increase in the preceding April. The reason for this change was due to the fall in wholesale gas prices associated with the poor prevailing economic conditions at the time. As a result of the shrinkage gas incentive, in which the GDNs recover costs associated with shrinkage gas through allowed revenue at the 'day ahead' price, NGN was at risk of over-recovering allowed revenue greater than the K deadband restrictions as set out in Special Condition E2.

Question 3.7: Are there any business processes that would mean only allowing one change per year on 1 April would not be feasible?
Response: We believe one change per year on 1 April is potentially feasible provided the issues discussed in our responses to Questions 3.3, 3.8 and 3.9 are fully addressed.

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?
Response: We believe it is imperative that the shrinkage gas allowance should be exempt from the K under or over recovery limits as suggested above, as this is largely due to wholesale gas prices which are out of the GDNs control. Any changes to pricing and charging methodology as directed from Ofgem should also be exempt from these conditions. Ofgem may also consider it suitable to allow intra-year price changes for specific one-off events, for example a significant change in regime due to a licence change.

Question 3.9: Do you agree with our proposed change to the penalty for over or under recoveries were this option to be implemented?
Response: NGN consider appropriate that if intra-year price changes are to be restricted to once or twice a year, the K deadband over-recovery percentages should be raised to 6% for the current notification requirement and to 10% for the current two year requirement. We believe this should provide the GDNs with sufficient headroom to justify the proposed pricing restrictions.

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?
Response: We have no objection to this proposal provided this is done on an NPV neutral basis.

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

Question 3.12: Do you think that introducing an additional licence condition to penalise NWOs when they make charge calculation errors is warranted?
Response: We believe this issue is specific to EDNs and therefore do not feel it is relevant for us to comment on this question.

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?
Response: We support the proposal whereby the reward/penalty for GDN performance in year t is reported in year t+1 and incorporated into our charges in year t+2, provided this is done on an NPV neutral basis with a mutually agreed cost of finance.

Question 3.14: Do you consider there to be any potential exemptions to our proposal to lag all incentive adjustments?
Response: Only the incentivised element of the shrinkage should be lagged, with an appropriate allowance incorporated into allowed revenue within year. We believe a two year lag on the period between when shrinkage gas costs are incurred and when they are recovered through revenue is unfair on GDNs as set out to our response to question 3.8 above.

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.
a) indexation
b) pass through costs
c) revenue drivers
d) within period determinations
e) reopeners
f) innovation funding
Response: We agree that no lag should be applied to these uncertainty mechanisms.

RPI and cost of debt indexation will be based on published mechanisms, e.g. HM Treasury forecasts for RPI and the iBOXX for cost of debt.

Pass through costs are generally relatively stable and therefore relatively straightforward to forecast in the short-term. Business Rates, for example, are generally increased by inflation annually and NGN work closely with external consultants in advance of any rates reviews to understand, and mitigate, the cost impact of such reviews wherever possible. Other pass through costs in GD-PCR1 have been largely stable and relatively predictable and are currently expected to continue to be throughout RIIO-GD1.

NGN agree the impact of within period determinations and reopeners will be known by the shippers in advance the adjustments to allowed revenue, as they will be subject to individual consultation processes. We feel it is therefore not appropriate to lag these adjustments any further.

We also agree that to incentivise innovation within the GDNs, any innovation spending should be funded within year with no lag. In general innovation projects have been accurately forecast by the sector within GD-PCR1.

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?

Response: NGN agree the benefits of introducing one of the three options for a cap and collar do not outweigh the drawbacks. Consequently, we do not support the introduction of any cap/collar mechanism.

Question 3.17: Do you consider there are any other options for the design of a cap/collar mechanism that we have not considered?
Response: We do not believe there are any further options for the design of a cap and collar mechanism to consider.

Question 3.18: Do you have any views on whether a cap and collar, if implemented, should be symmetric or asymmetric?
Response: We do not support the introduction of a cap/collar mechanism and therefore do not have a view as to whether this should be symmetric or asymmetric.

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?
Response: We agree that any changes needed in both sectors should be implemented on 1 April 2013.

Question 3.20: When should we apply any changes to the electricity distribution sector?
Response: We do not think it is relevant for us to comment on this question.