Joanna Campbell
Ofgem
9 Millbank
London
SW1P 3GE

Inveralmond House
200 Dunkeld Road
Perth
PH1 3AQ

Tel: 01738 456107
Date: 11 June 2012

Dear Joanna,

Mitigating network charging volatility arising from the price control settlement

SSE and Scotia Gas Networks (SGN) welcome the opportunity to comment on the above Ofgem consultation.

We fully support the proposals to introduce measures to mitigate charging volatility and ensure that suppliers and shippers are well informed of any changes. As part of the Ofgem RIIO-GD1 price control settlement process a number of SGN's stakeholders highlighted the issue of network charging volatility as a material impact on the way they structured their charges to their end consumers. We also agree that it is appropriate for Ofgem to focus on volatility in allowed revenue, and not to consider changes to charging methodologies in this consultation but for these instead to be discussed through the existing industry codes' processes.

Our responses to the questions given in the consultation are attached as an Appendix to this letter. In general, we agree with Ofgem's assessment of the five proposed options. The implementation of options one, two and most of three should significantly improve suppliers' ability to understand and forecast changes. Options four and five, and the proposal in option three to add a two year lag to the shrinkage incentive for GDNs, would result in significant risk being placed on network operators (NWOs), and could potentially lead to increased pressure on cashflow liquidity. In our view, these options would add limited value to the other options that are being considered and we do not believe they should be progressed further. However, if these options are pursued then the implementation phase should include an explicit recognition of the additional risks in the cost of equity for the NWOs.

When considering the implementation of the proposals it is important to ensure that any interactions with the Retail Market Review are looked at. Furthermore, implementation needs to be aligned to the RIIO-T1 & GD1 licence drafting and development of the financial handbook for determining revenues.

If you would like to discuss any of our response further, please do not hesitate to contact me.

Yours sincerely,

Aileen McLeod
Head of Regulation, Networks

Appendix: response to consultation questions

CHAPTER TWO

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

Yes. The general scope of the issue of network charging volatility within the consultation document appears to have been accurately assessed in relation to the potential impact of risk premiums applied by domestic suppliers on domestic customers' gas and electricity bills.

The issue of creating a barrier to market entry is, however, a little more unclear as we would expect new market entrants to be aware of any network charge fluctuation over a historical period and where necessary to price their supply tariffs accordingly, taking into account any risk premium they need to apply.

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

Charging volatility has affected all types of customers. Volatility of charges in electricity distribution is a particular issue which has worsened with the introduction of the CDCM. Large Industrial and Commercial customers (including EHV) have been the most affected.

In general, it is the predictability of these charging changes that needs to be addressed. This should remove or weaken the requirement for any risk premiums to be factored into supplier charges and would further provide a strong basis for industrial/commercial customers, contracting through pass through tariffs, to forecast their yearly energy costs.

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

We consider the assessment criteria to be correct.

In addition, we would suggest consideration of links to wider policy making bodies, such as DECC and directives stemming from the European Parliament which may impact on the way NWOs have to charge for the services they provide.

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?

SGN has considered and put forward a number of proposals in this area. In its RIIO-GD1 business plan several proposals are made, including the proposal to introduce a lag on incentive payments and penalties. We note that these have been discussed in the consultation. In addition, SGN has also already taken the opportunity to profile its base revenues in order to limit charging volatility.

Further, SGN has sought to introduce measures into the Uniform Network Code under Modification 0404 to reduce the impact that overall gas distribution network charges have on small shippers and suppliers, by providing them with the ability to mitigate network charge changes via improved cash flow arrangements in this area.

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

In general, yes. Our responses to the specific questions below highlight any areas of disagreement.

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?

The misalignment between gas distribution and transmission network charging change dates may result in an increased risk of SGN's NTS Exit Capacity charges to shippers to be out of step with NTS' allowed revenues and subsequent charges. This issue could be resolved by more closely aligned distribution and transmission charge notification dates.

In addition, it is important that charge notification dates are well publicised. We have noted that NGC price change publication dates are not well advertised and the notifications can be difficult to locate on their website. A clear statement of the publication dates on the website would be helpful.

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.

It would be helpful if all network price change notices were required to state:-

- the average price increase over all customer types;
- the price increase for every individual tariff type; and
- the reasons for both of the above.

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?

From a Shipper/Supplier perspective the proposals in Q3.4 above will suffice.

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?

Our electricity and gas distribution and electricity transmission businesses endeavour to change network charges only once a year, on 1 April. There have been occasions where, due to changes to our charging methodologies or other unexpected events, we have also changed our tariffs on 1 October. We have always sought to keep these intra-year changes to a minimum.

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

We note Ofgem's recognition of this issue detailed within paragraph 3.41 of its consultation and would support the accompaniment of a prohibition on intra-year changes with a widening of the permitted band before any penalties were applied. We are also supportive of retaining the current penalties at the levels applicable to the current price controls.

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?

We agree that there needs to be a mechanism to allow the Authority to grant a change to tariffs outside of 1 April on a case by case basis. Such cases would include errors when calculating charges and changes to charging methodologies. Other events that should potentially be exempt could include policy and legislation changes.

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

Yes. If NWOs are restricted to changing charges once per year, the band within which the penalty rate for over or under recoveries applies should be extended. Widening the band but keeping existing penalty rates, as proposed in the consultation, seems sensible. It is important to note that the current differences in bands across sectors reflect the varying levels of uncertainties faced, and the subsequent ability to accurately forecast, in each sector. Such differences should therefore remain if the bands are to be extended.

We note that Appendix 3 of the Ofgem consultation does not include the following existing requirement under the electricity transmission licence:

'Special Condition J6: Restriction of transmission charges: adjustments

1. If, in respect of any relevant year, the regulated transmission revenue exceeds the allowed transmission owner revenue by more than 3 per cent of the latter, the licensee shall furnish an explanation to the Authority and in the next following relevant year the licensee shall not effect any increase in charges for the provision of transmission services, the revenue from which is regulated under Special Condition J2 (Restriction of transmission charges: revenue from transmission owner services), unless it has demonstrated to the reasonable satisfaction of the Authority that the regulated transmission revenue in that next following relevant year would not be likely to exceed the allowed transmission owner revenue in that same relevant year.

2. If, in respect of any two successive relevant years, the sum of the amounts by which the regulated transmission revenue has exceeded the allowed transmission owner revenue is more than 4 per cent of the allowed transmission owner revenue for the second of these relevant years, then in the next following relevant year the licensee shall, if required by the Authority, adjust its charges for the provision of transmission services, the revenue from which is regulated under Special Condition J2 (Restriction of transmission charges: revenue from transmission owner services), such that the regulated transmission revenue would not be likely, in the judgement of the Authority, to exceed the allowed transmission owner revenue in that next relevant year.

3. If, in respect of any two successive relevant years, the regulated transmission revenue is less than 90 per cent of the allowed transmission owner revenue, the Authority, after consultation with the licensee, may direct that in calculating K_t in respect of the next following relevant year, there shall be substituted for AR_{t-1} in the formula set out in paragraph 3 of Special Condition J2 (Restriction of transmission charges: revenue from transmission owner services) such figure as the Authority may specify being not less than AR_{t-1} and not more than $0.90(TO_{t-1})$.'

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?

We do not agree that a two year lag should be introduced as this would introduce a significant cash flow risk on NWOs. Although every attempt is made to forecast accurately, the potential remains for an under-recovery to be made. A significant under-recovery could result in a serious cash flow issue for NWOs if they were unable to recover the additional costs from shippers for two years. Our preference would be, if required, for a smoothing mechanism.

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

No.

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

No. In the efficient operation of their businesses we consider that NWOs make every effort to ensure that no errors are made. Additionally, and as discussed in the consultation, NWOs are already penalised for any significant errors as this would likely result in an over or under-recovery. It would be inappropriate to be doubly penalised for any such error. However, it is important that any such errors are thoroughly investigated and the root cause identified and corrected.

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?

A two year lag would be appropriate for the majority of incentive mechanisms.

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

Gas shrinkage should be excluded from any lag as the vast majority of financials associated with this area are a direct cost to the NWOs. As such, introducing a lag could result in significant cash flow issues for NWOs.

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

We note and agree with Ofgem's conclusions regarding the inappropriateness of such a lag for indexation, within period determinations and innovation funding. Furthermore, we consider that it would not be appropriate to apply a lag to any of the other uncertainty mechanisms as such action would increase cash flow risk for NWOs with little or no benefit to customers or other stakeholders.

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 that the benefits of introducing a cap and collar under options 1 and 2 do not outweigh the drawbacks. All options would place significant and inappropriate risk on NWOs.

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?

No.

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

As noted above, we do not consider that a cap and collar should be introduced.

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?

Yes. However it is important that the interaction with the Retail Market Review proposals is also considered. It will also be important to ensure that sufficient notice is provided of the introduction of any changes to allow for their smooth introduction.

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

Restricting the changes to charges to once per year could be introduced from 1 April 2013. However, the introduction of any changes to the fundamentals of the price control, such as lags on incentive rewards and penalties should be delayed until the start of ED1.