TOTAL GAS & POWER

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Dear Joanna,

Total Gas and Power Ltd (TGP) response to mitigating network charging volatility arising from the price control settlement

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

TGP generally agrees with the scope laid out in the consultation document. We however believe that stability (knowing that a price will not deviate more than certain percentage) provides as much, if not more, benefit than knowing what the price change will be as this provides a manageable risk for both shippers and customers.

Another important factor to consider it the notice period provided to suppliers of any price change as the more notice that suppliers is, the easier it is to manage with respect to pass through to consumers.

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

Charging volatility has very different effects on domestic and non-domestic customers. In the domestic sector, transportation charges are one element (along with gas cost, administration costs, etc) that are incorporated into the price of the tariff that the supplier is offering. This means that unexpected variations in transportation charge will impact on the profitability of supply to these customers and may result in additional margins being built in , but will not in itself result in additional administrative costs for the customer or the supplier. However the key point with respect to the domestic market is that domestic suppliers can raise their tariffs at any point to compensate for any increase in transportation or any other costs. This is not possible in the non domestic market.

Non-domestic customers are supplied on bespoke contracts that will be priced based on the transportation cost at the time. Generally there are two types of non domestic contract, fixed contracts and pass through contracts. With respect to fixed contracts, the contract price is agreed at the beginning of the term based on prevailing market conditions and known fixed costs. Should these costs change at any time during the contract period, suppliers will be unable to pass these costs on to the consumer. Suppliers will therefore price a risk premium into the contract price to reflect this. The greater the uncertainty, the greater this risk premium will be. This is obviously undesirable from a consumer perspective.

For pass through contracts any variation in transportation charge will be passed onto the non-domestic customer. This has three main impacts. Firstly each change in transportation costs results in administrative costs being incurred by the customer and supplier in adjusting the rate charged. Secondly a supplier when compiling the price is likely to add an additional premium to compensate for these administrative costs. Finally, a lack of stability and predictability in the charges means that the customer is unable to plan for these costs in the long-term and so is exposed to any unexpected variation.

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

The proposed criteria seem appropriate.

<u>CHAPTER: Three</u>

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?

Not at this present time.

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

Further to our responses below, we see an overall benefit to all five options proposed. Our primary concern is that options 1-3, whilst in theory will provide benefits do not seem to alter the current framework in a great degree. Most networks only adjust prices once a year at present. We are not convinced that sufficient information can be provided with any certainty more than at present and lagging of incentives is unlikely to limit volatility, although it would allow suppliers to manage the pass through of the charges more effectively. We believe that options 4 and 5 should not be discounted and indeed are seen to be the preferred ways forward.

<u>Specific questions in relation to option 1:</u>

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

TGP operate in both the electricity and gas markets and sees a benefit in harmonising, where possible, the change management processes as this results in a reduction in the industry regulatory burden, so reducing costs to the consumer.

TGP believes that a central charge notification mechanism should be considered so that all regulated parties in both gas and power could publish any changes to

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charging in one place. This would make it easier for suppliers to manage the administration of changes rather than having to search in many different websites and postal notifications.

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 charge 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.

TGP would like to see a forward 5 year view of distribution and transmission charges (as is the case in the electricity market). Then, where charges out-turn differently to the forecast charges TGP would like to see a robust and easy to understand explanation for those differences so that this can be communicated to customers who are often bewildered as to why they are incurring additional and unanticipated costs.

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?

TGP would like to see Ofgem using the next price control as an opportunity to eradicate charging volatility and increase reliability. There is now a short window in which to do this.

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?

There have been changes or notifications of potential charges for four of the last five years. These changes (or proposed changes) have been due to differences between the expected rate and actual rate of mains replacement work and changes to charging methodologies. Both of these areas are within the control of the transporters.

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 are not aware of any.

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?

The primary benefits for restricting changes to transportation charges is to provide certainty to shippers as to what their transportation costs will be, so minimising any

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premiums built into their contracts or tariffs and reducing the significant administrative burden of multiple transportation cost adjustments. The possibility of exemptions destroys this benefit. There should be no possible exemptions and instead other mechanisms utilised to compensate for any short-term benefit or loss to the transporters.

The only possible exception is where transportation charge error is so material that it may distort the operation of the market. We would expect that these circumstances would be extremely rare (we are not aware of such circumstances happening in the past) and so an ad hoc process could be utilised in this instance.

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

There is a need to ensure that transporters are incentivised to accurately price their transportations charges to meet their allowed revenue targets. A penalty regime would achieve this but simply increasing the current tolerances still leaves the perverse incentive of intra-year adjustments to avoid penalty charges. Another possible option is to charge unfavourable rates of interest on any over or under-recovery.

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 believe that a timelag, whilst helpful, is likely to be of comparatively little value as it still may result in significant changes to allowed revenue and hence transportation charges. Large jumps in transportation charge are difficult for customers to handle, irrespective of the notice provided. As we proposed in UNC Modification 0368, staggering the introduction of any adjustments (over a four-year period say) will ameliorate the impact of any adjustment.

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

We have not examined the past history of network charge calculation and so are not in a position to answer this question.

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

Yes, networks should not make errors when calculating their charges and so they should face the consequence of any errors they make so that they are penalised in the same way that their customers and end consumers are. We are open to the mechanism by which this achieved, but a licence condition that explicitly places penalties on transporters would provide the necessary incentive.

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 note that recent changes to the current distribution charge regime[1] have allowed approximately 18 months lead-time for the changes to take effect. It should be noted that a key determinant of this lead time (which historically had been much shorter) was not the system changes needed to take into account the new processes, but the notice period necessary for the new charging levels to be priced into contracts. Changes to the value of transportation charges themselves, which have the same impact, should be seen in the same light and so have the same 18 month lead time as a minimum.

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

The primary benefit for incorporating a lag mechanism is to provide certainty to shippers as to what their transportation costs will be, so minimising any premiums built into their contracts or tariffs. The possibility of costs to be "fast-tracked" destroys this benefit. There should be no possible exemptions and instead other mechanisms utilised (such as the logging-up mechanism currently being employed for the price control) to allow incentive adjustments to be taken into account in the short-term.

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

Further to our response in Question 3.10, we believe that a lag mechanism should be consistently applied to all uncertainty mechanisms. A mixed process will remove any certainty gained by introducing a time-lag to adjustments.

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 disagree with the assertion that transporters are somehow in less of a position to absorb the uncertainty risk of temporary under or over-recovery of transportation charges in a given year. Unlike suppliers, transporters are guaranteed a level of

[1] DNPC08: Review of Standard LDZ System Charges, DNPC07: LDZ System Charges Capacity Commodity Split & DNPC06: Proposals for LDZ Charges to Recover NTS Exit Capacity Costs

revenue from their customers (in this case shippers) and also, unlike suppliers have a significant asset base to borrow against. This will mean that any cost of capital to cover shortfalls that may result from under-recovery of costs will be far lower than for suppliers who would otherwise be expected to cover the shortfall. This ultimately means that placing the risk on transporters will significantly reduce the costs incurred by the industry in handling any mismatch between expected and recovered revenues.

We also disagree with the statements that caps and collars will somehow weaken transporter incentives for accurate forecasting. Instead we would suggest that it strengthen their incentive for accurate billing knowing that errors, above a certain level, could not be passed on through the next set of transportation charges. In addition there seem to be significant benefits to the Transporters in a cap or collar regime, specifically that it guarantees a certain level of revenue, and hence shareholder return, each year.

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 believe the options specified are adequate.

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

The primary purpose of any cap of collar would be to ensure that customers are not exposed to sudden, unpredictable and erratic swings in their costs. To that end any significant decrease in transportation charges, though preferable to a significant increase, creates additional administrative cost for suppliers and customers as well as resulting in a significant increase in volatility as an under-recovery is likely to be compensated by large increases the following year. To achieve the aim of stable and predictable transportation charges both under and over recovery need to be treated equally.

We note that the current framework effectively results in a asymmetric collar, as the transporters are expected to take all reasonable steps to prevent over-recovery of transportation, but do not have the same level of obligation for under-recovery[2]

<u>Timing of implementation:</u>

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?

As stated above there is a clear benefit to altering the current charging arrangements which place significant costs on suppliers (and ultimately customers). The only argument against undertaking these changes as soon as possible is to provide sufficient time for the transporters and shippers to incorporate them into their

[2] Special Condition Part E2B

processes and for any consequent licence changes to be undertaken; April 2013 would therefore be a sensible date.

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

In line with Ofgem's better regulation principles, there is merit in aligning the processes in both gas and electricity as far as practical. So, in line with our comments above, as there seems to be no need to link these changes with a price control we feel that April 2013 would also be an appropriate time for changes to occur in electricity.

Should you wish to discuss any of the above in more detail, please do not hesitate to contract me,

Yours Sincerely

PP [illegible]

Andrew Green

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