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Mr. Jacob Kane  
Ofgem  
Distribution Policy  
9 Millbank  
London  
SW1P 3GE

Dear Mr. Kane,

**Re: Independent Gas Transporter's Relative Price Control – Consultation on revising the guidance document and potential changes to Special Condition 1 of the IGT licence**

I am writing on behalf of the ESP Utilities Group (“ESP”), incorporating the independent Gas Transporters; ES Pipelines, ESP Connections, ESP Networks and ESP Pipelines. ESP’s response to the above consultation is as follows.

**Question 1:** Do you agree that it is no longer necessary for us to carry out our current monitoring role of IGT charges under the RPC?

ESP agrees that it is no longer necessary for Ofgem to carry out their current monitoring role. Under a recent modification to the iGT-UNC (iGT043VV), as of the 28<sup>th</sup> June, shippers will have all the information required (together with the commercial incentive) to carry out their own monitoring of iGT charges, to a greater level of detail than the current monitoring carried out by Ofgem.

ESP believes that the correction of the licence and the clarification offered through the RPC guidance notes will both reduce the number of discrepancies found in iGT charges and simplify the task of monitoring the charges for shippers.

**Question 2:** Does this change to the guidance make this issue clear?

ESP agrees with Ofgem’s licence interpretation and the change to the guidance notes does now make this clear.

**Question 3:** Does the revised guidance provide sufficient clarity or do we need to amend the licence?

ESP agrees with Ofgem’s interpretation of the licence condition’s intent and the revision to the guidance notes clarifies this. However, based on legal advice taken, ESP believes that the drafting of the licence condition leaves room for different interpretations and does not make this entirely clear. With the content of the licence taking precedence over the guidance notes, the potential risk of an alternative interpretation being put forward to challenge Ofgem’s interpretation remains.

The number of years for which the surcharge will apply is a key element in determining the level of investment made in a project, therefore the licence condition should ideally be redrafted to ensure the correct interpretation is maintained.

ESP does appreciate that, for practical reasons, a licence change for this particular issue is best avoided if an alternative solution is available. If no additional changes to the licence are required, ESP would accept a clarification in the guidance notes, anticipating that a challenge to the interpretation would then be unlikely. However, if other changes to the licence condition are being made as a result of this consultation, ESP asks that Ofgem consider amending the licence to fully reflect the interpretation put forward in this consultation.

**Question 4:** Should we proceed with licence changes (and a full statutory consultation) to address this issue?

ESP strongly believes that the original intention of RPC was to ensure that between the Floor and Ceiling, iGT charges should match the GDN's charges. The current drafting of the RPC formulae does not ensure this and fails to take into account the potential for the GDN's charges to fluctuate below and above the Floor and Ceiling. This is a scenario that ESP believes was overlooked when the formula was originally drafted, but has since been highlighted through the practical implementation of RPC. Further clarity on this issue, including the possible reasons for this discrepancy, can be found in Appendix 1.

In addition to this element of the licence condition's drafting not reflecting the intent of RPC, there are a number drafting errors (some of which have been rectified over time, since the condition's original publication) that ESP has highlighted in previous submissions to Ofgem. Appendix 1 describes a number of these drafting errors picked up on by ESP and other transporters. This adds credence to the conclusion that the discrepancy in the methodology is due to an error that was not identified in the final stages of the condition's drafting.

This discrepancy around the calculation of RPC charges is something we believe should be rectified to ensure no future deviation from the original intention of RPC – that is, that between the Floor and Ceiling, the iGT charge should match the GDN charge. Any deviation could be material and as such, ESP feels this does warrant a full statutory consultation. We agree with Ofgem that the current methodology creates uncertainty for both the iGT and the customer and believe that Ofgem has a duty to rectify this issue in order to reduce this level of uncertainty.

ESP would regard any statutory consultation as a correction of the licence condition's drafting and not a change to the RPC methodology.

**Question 5:** Is our intention on this issue clear. If not, what steps should be taken to make this clearer?

ESP agrees with Ofgem's interpretation of the licence condition's original intent, which the guidance notes have made clear. ESP does however believe, based on legal advice taken, that the licence condition is likely to be interpreted as giving iGTs the choice as to whether to increase their quarter four charges or not. ESP is concerned that given that the licence supersedes what is written in the guidance notes, there is a risk of Ofgem's interpretation being successfully challenged.

Increasing quarter four charges is often beneficial to an iGT. With this commercial incentive comes an increased likelihood of an iGT challenge to the guidance notes. Should an iGT successfully challenge the interpretation, other iGTs will have little choice but to follow suit in order to maintain their competitive position. ESP therefore believes that the licence condition needs to be changed in order to mitigate this risk.

**Question 6:** Are there any other drafting issues that you feel may need addressing by amending Special Condition 1 of the IGT licence?

There are two further drafting errors that ESP would like to draw Ofgem's attention to. They are as follows:

1. The purpose of Paragraph 2(3) is to specify how iGTs should determine the Annual Quantity (“AQ”) for domestic premises. This is intended for new housing only, where standard AQs are available. For infill properties, this is not applicable and so for the purposes of this paragraph it is stated that domestic premises where a surcharge is made are excluded.

However the infill surcharge is an optional charge and so may not be applied to all infill projects. Consequently any infill connections without a surcharge are, in theory, covered by Paragraph 2(3) even though there are no standard AQs available. This is clearly a drafting error where the assumption that all infill projects will have a surcharge has been incorrectly made (note: this is an example of where the potential scenarios have not been fully mapped out when drafting the licence condition). Nonetheless the licence condition needs to be corrected so **all** infill connections are excluded from Paragraph 2(3).

2. There is also a drafting error in the formula at Paragraph 2(b) where  $TC_1$  should read  $TC_t$ . (Note: this error was actually highlighted for correction in the drafting of the licence but was not subsequently changed. This is an example of where a licence condition has been drafted incorrectly, even though obvious mistakes were highlighted prior to the final version being published). Although a clear mistake, iGTs could still use the formula with  $TC_1$  in calculating transportation charges. Given that iGTs presently use  $TC_t$ , each iGT is technically in breach of their licence until such a time as this formula is corrected.

ESP would accept that these may be considered minor errors, in that they are clearly wrong and the impact of correcting them should not be considered material given that it would not alter the current practice among iGTs. However, as both errors appear in key elements of the licence condition, it technically puts affected iGTs in breach of their licence. Therefore, although only a house keeping exercise, ESP believes an amendment to Special Condition 1 should be carried out to ensure that iGTs are complying with their licences.

Failing a change to the licence, a letter from Ofgem making it clear that these are drafting errors that would not be considered a licence breach should be provided to the iGTs. The risk of Ofgem failing to either make these changes or to provide such a letter is that iGTs may consider it necessary to seek a disapplication in order to protect their position.

## General Comments

ESP believes due to the number of drafting errors and ambiguities identified, there is a clear requirement for a licence change to ensure the licence condition accurately reflects the true intentions of RPC. This would also ensure that there is no disparity between the licence condition and the guidance notes. ESP would support bundling all the required licence changes into one change process, as the most efficient means of fully aligning Special Condition 1 with the original intent of RPC.

If you would like to discuss ESP’s response in more detail please not hesitate to contact me on 01372 225 506.

Yours sincerely

Adam Pearce

**ESP Utilities Group**

## Appendix 1

### **ESP Utility Group**

#### **Relative Price Control Discrepancy in the Calculation of the iGT's Charges**

##### **Introduction**

From discussions with Ofgem regarding the clarification of the guidance notes for the calculation of the independent Gas Transporter (iGT) relative price control (RPC) charges, a discrepancy has been identified in the calculation of the charges that in the opinion of ESP Utilities Group (ESP) needs to be rectified in order for the charges to fully reflect the intended purpose of RPC.

##### **Original Aim of RPC**

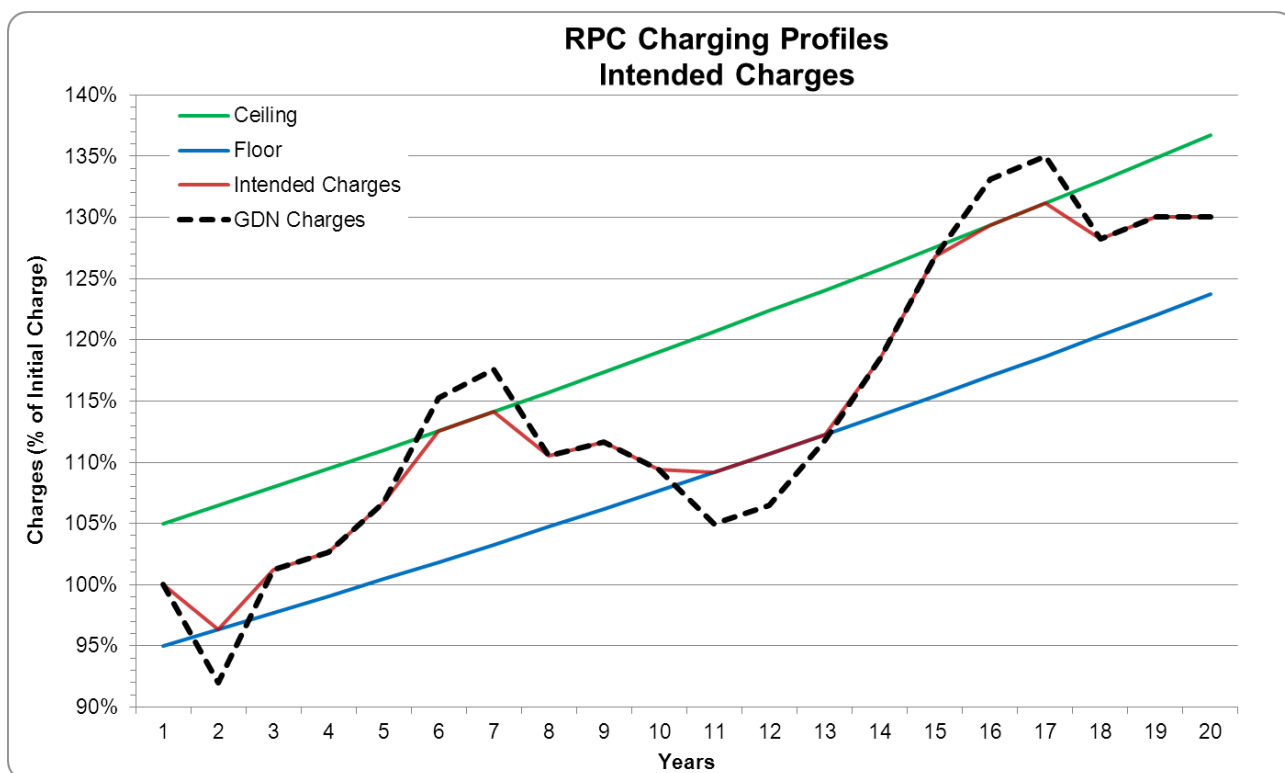
RPC was introduced as a result of concerns over the previous charging methodologies used by the iGTs that caused a wide range of charges, many of which produced higher overall transportation charges when taken with the GDNs' charges to connection point of the iGTs' network (the "all the way charge"). This made transporting gas to end users on iGT networks increasingly more expensive than transporting gas to the equivalent end user on the GDNs' networks. Consequently RPC was introduced with the primary aim to ensure the iGTs charges reflected the equivalent proportion of the GDN charges so that shippers (and so end users) would be charged the same all the way charges for the same type of customer whether they were on an iGT network or the associated GDN's network.

On its own however, this did not give the required level of investment protection to the iGTs and so the concept of a Floor and Ceiling was introduced. It was envisaged that between the Floor and Ceiling the iGTs should follow the equivalent proportion of the GDN charges, as is the key principle of RPC. However should the GDNs' charges go below a defined level (the "Floor") the iGTs' charges did not need to follow but stayed at the Floor. In recognition of this downside protection an upper level (the "Ceiling") was also agreed that provided the potential of lower iGT charges if the GDN charges increased at a higher rate than anticipated.

In support of ESP's view, as part of the Ofgem consultation on the RPC regime in 2003, Ofgem stated that:

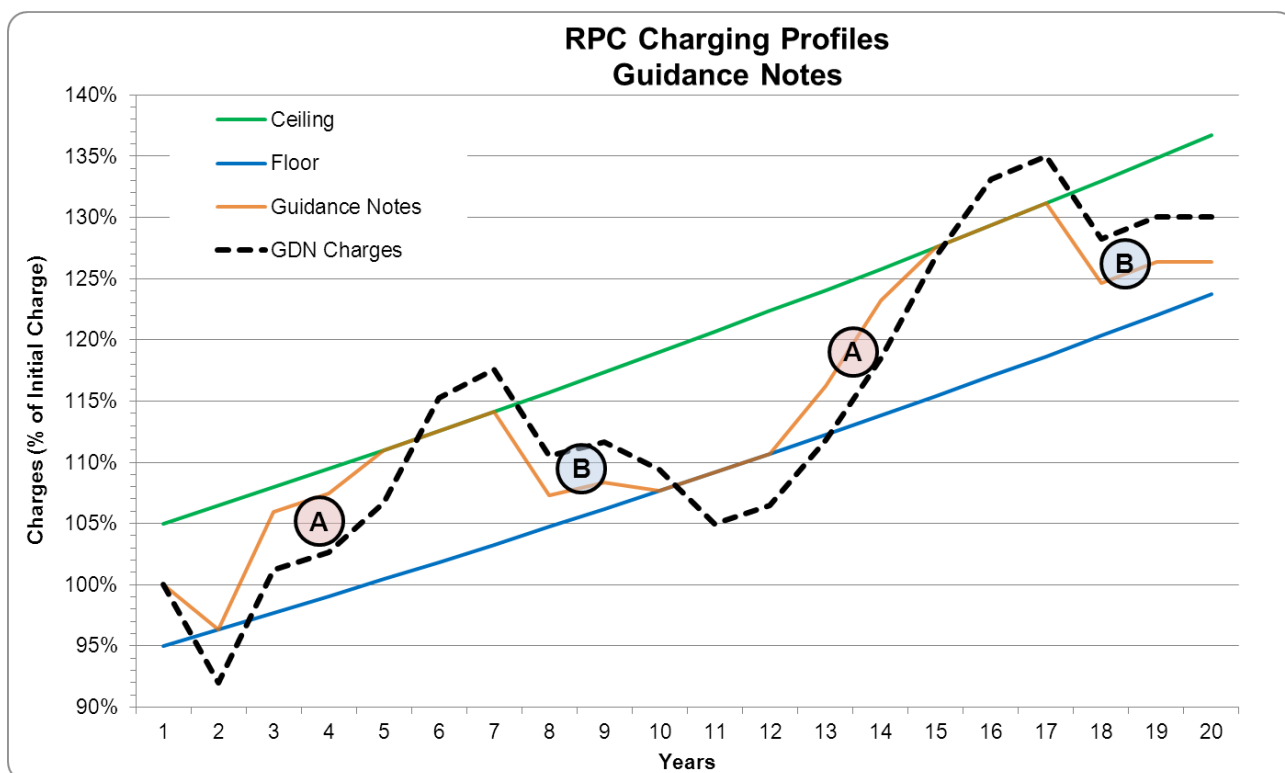
*"The path of future IGT charges would follow the change in Transco's SSP charge from one year to the next within a pre-determined floor and ceiling".*

Although this did introduce an element of risk to both shippers and iGTs that the all the way charge may be higher or lower when outside the Floor and Ceiling, neither party would be disadvantaged or advantaged when between. This is illustrated by the following graph (note that the figures used are not actual, but are theoretical used to illustrate possible trends).



### Licence Calculations

The resulting RPC calculations have however deviated from the original principle of iGT and GDN all the way charges being the same between the Floor and Ceiling, as it does not use the GDNs' previous year's charges as the principle point to calculate the new iGT charges. Instead it takes the previous year's iGT charge and changes this by the same amount as the GDNs' charges. This causes the iGT's charges to deviate away from the GDN's charges between the Floor and Ceiling once either the Floor or Ceiling has been breached. This is illustrated by the flowing graph.

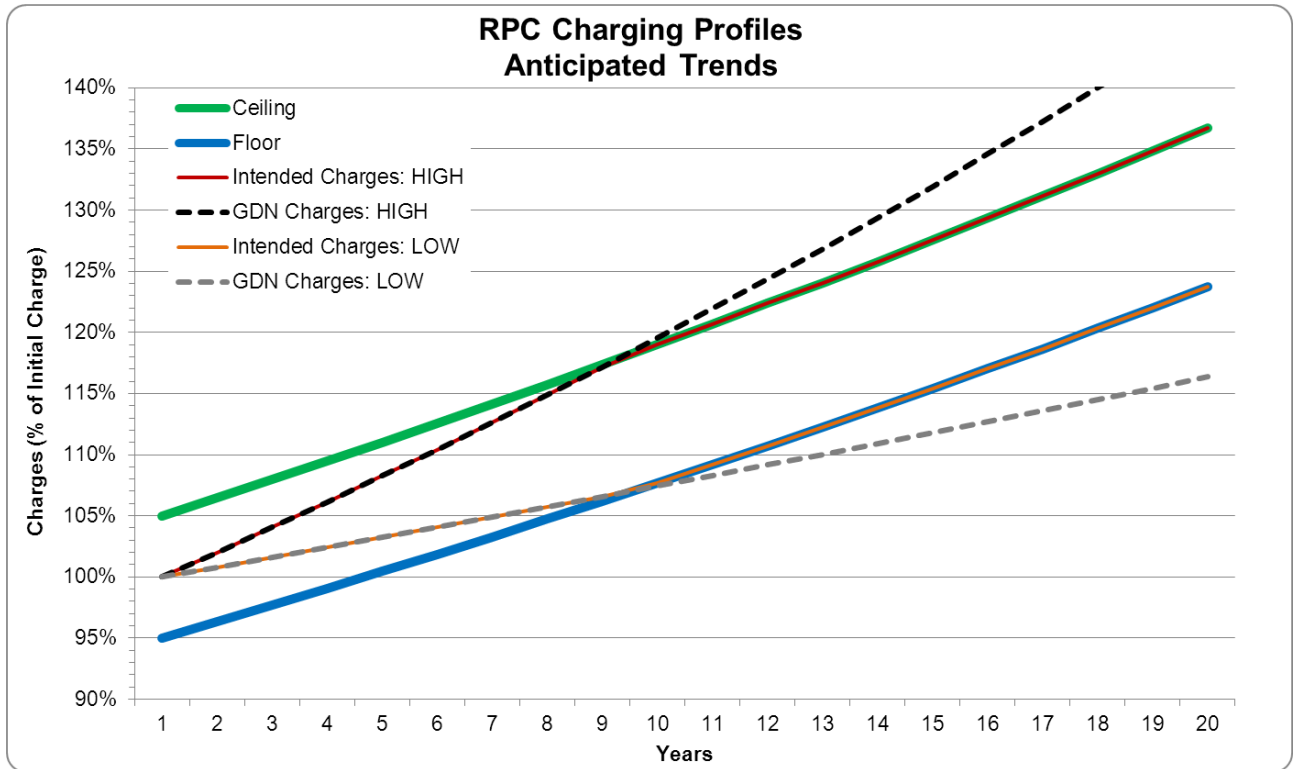


It can be seen from the graph that depending on the circumstances either the iGT charges are more than the GDNs (shown by A) and so are detrimental to the shipper and end users, or alternatively are less than the GDNs (shown by B) which is detrimental to the iGTs. This is clearly not following the principles of RPC as it does not provide the level of price stability expected, nor is it “relative”.

ESP cannot find anything from the consultations on RPC that explicitly highlights that there was in fact an intention to deviate from the basic principle of RPC in such a way, or the reasons for doing so. Therefore ESP believes that the true intentions of RPC were not correctly translated into the RPC licence conditions resulting in this discrepancy.

### **Possible Reasons for Discrepancy**

It has been surmised that deviation from the original intention of RPC may have come from the apparent assumption in the examples used during the consultation process that the GDN charge would, if it breached the Floor or Ceiling, continue downwards or upwards and not later come back to between the Floor and Ceiling, as illustrated by the graph below. On this assumption the calculation would appear to work as it would keep the iGT charge at either the Floor or Ceiling. However an analysis of the charges alternating between the Floor and Ceiling does not appear to have been carried out which would have highlighted the deviation from the GDN charges.



Further investigation into the consultation process found a lack of clarity in the descriptions as to how the iGT charge is calculated after it passes the Floor and Ceiling. This left the matter open to an individual's interpretation of how it should be done, and would not have highlighted the potential deviation from the intended aim of RPC.

## **Supporting Evidence of other Drafting Errors**

As evidence to support the fact that there is a drafting error in the RPC formulae, the following identifies further areas where Special Licence Condition 1 (RPC) contains other ambiguities and/or errors. Included are references to publicly available documents relating to these errors.

1. Error in Formulae  $TC_{4t} = F_t$  where “1” was used instead of a “t”. This was highlighted as wrong but then not corrected in final licence draft (sent by John Holmes 11/12/2003).
  - *Covering Letter: 1A\_ESP letter licence modification.doc*
  - *Marked up licence condition: 1B\_RPC special condition final revision.doc*
2. Only examples of where Transco’s charges breaching the ceiling or floor were considered as part of the original consultation; Transco’s charge fluctuating between the two was not taken into account. (Note these were early on in the consultations and the final methodology adopted was different to that described.)
  - *A letter sent 24/03/2003 by Frances Warburton: 2A\_Letter on form of RPC 24 Mar 2003.doc*
  - *A letter sent 03/03/2003 by P Mohamed: 2B\_Presentation to IGT workgroup.ppt*
3. The required change to the guidance notes to allow an alternative method of charging for I&C sites. The original methodology did not take into account changes in I&C Aqs that would cause a significant deviation from the Transco equivalent charges. This meant that I&C RPC charges did not give I&C customers the level of intended protection under RPC. There was correspondence between ESP and Ofgem explaining why this was a mistake that should be rectified.
  - *A letter sent 28/09/2004 by Indra Thillainathan: 3A\_Revised RPC guidance small IC charges SP .doc (this is just the final letter sent by Ofgem making the subsequent changes).*
4. The fundamental error that required a change to the calculation of the CSEP charges. ESP assumed this came about because Ofgem only considered domestic-only networks when it carried out its calculations, not appreciating the impact that a mixed network would have on the calculations. This is an example where only one scenario was used when developing certain RPC calculations, similar to the consideration given to the GDN’s charge only breaching the floor or ceiling but not fluctuating between the two.
  - *A letter sent 16/12/2004 by Indra Thillainathan: 4A\_csepletter2.doc*

ESP has also had feedback from other parties, indicating that the first version of the RPC licence condition may have contained other errors in the calculations that subsequently needed correcting after the RPC licence condition was issued.

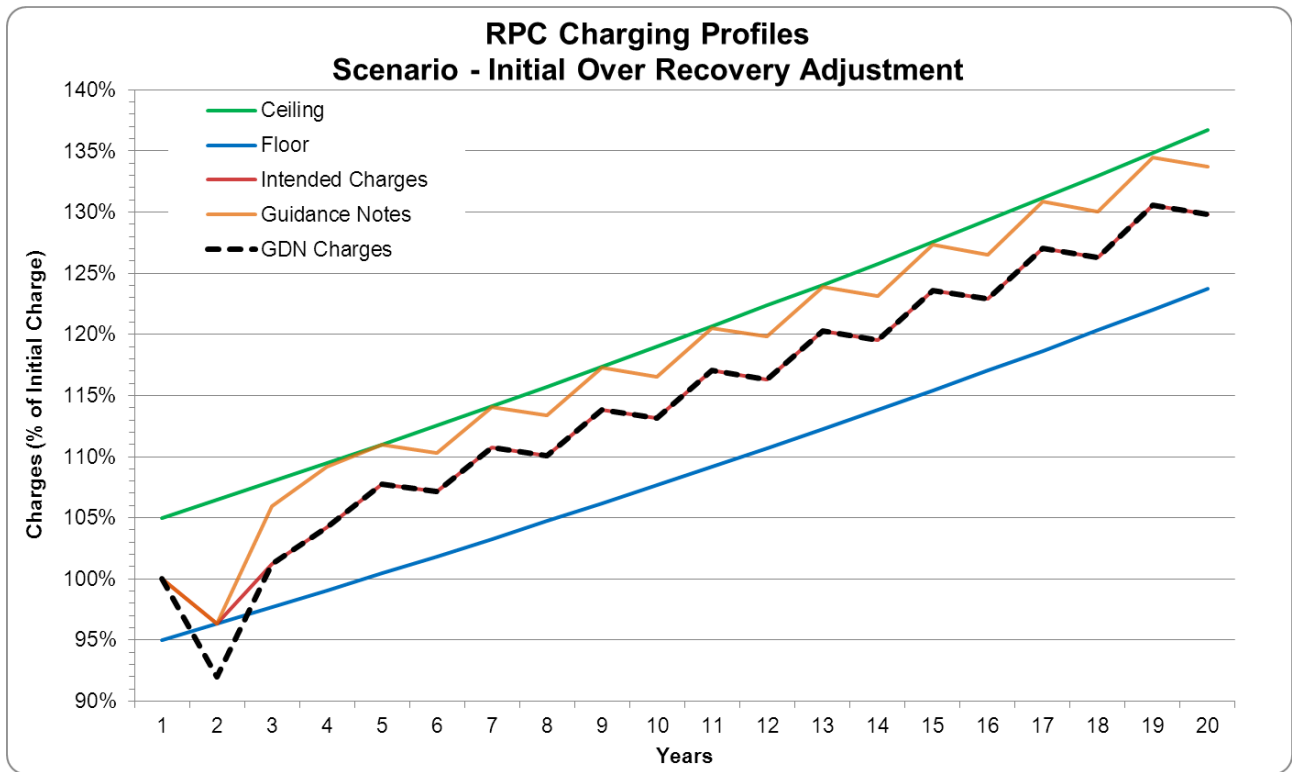
## **Implications of Discrepancy**

Currently this deficiency has not been highlighted as the GDN charges have by and large increased at a greater rate than the long-term projections used to calculate the Floor and Ceiling. Consequently where there has been a breach it has been at the Ceiling and then subsequent changes in the GDN charges have kept the iGT charges at the Ceiling for most of the time. However the GDN charges are subject to significant correction at times, particularly when there has been a large under or over recovery of charges. This has already happened in 2011 when some of the wSSP indexes were negative producing a noticeable deviation in some regions.

Looking ahead there is a real risk that the iGT charges could again deviate from the GDN charges between the Floor and Ceiling. As an example the following graph illustrates the



scenario where there is an initial reduction in GDN charges to reflect an over recovery followed by the GDN charges broadly following the Ofgem projected profile (note this would apply to new projects introduced at year 1). This shows the potential for the iGTs' all the way charge being higher than the GDNs', a scenario the introduction of RPC was specifically meant to prevent.



As a guide to the potential cost implications, the average iGT transportation charge is in the order of £50 per year therefore a 10% deviation, the maximum possible, would represent £5 per year. With around 1.5 million iGT gas connections this in the most extreme case would be £7.5 million.

## Correction to the Calculations Required

The calculations do not follow the basic principles of the RPC Methodology and should be modified to reflect the intended purpose. ESP would put forward two possible options for doing this, as follows:

**Option 1:** The definition of  $TC_{t-1}$  is changed as follows:

$TC_{t-1}$  means the maximum charge the licensee may charge each premises ~~subject to paragraph 2 of this condition in the year preceding year 't' or part thereof~~; or, where charges have been restricted to a charge ceiling or charge floor in any year from the entry point to year 't', the notional maximum charge that would apply had such charge ceiling or charge floor not been applied

**Option 2:** A relatively simple change in the calculations with it being clarified that the previous year's charge used should be the GDN's equivalent charge (i.e. what the iGTs' charge would have been without a Floor and Ceiling) not the iGTs' current maximum allowable charge, as shown below.

Change formula (wherever shown) to following:-

$$TC_t = \overset{TU_{t-1}}{\circlearrowleft TC_{t-1}} \times \left( 1 + \frac{wSSP_r}{100} \right)$$

Insert a new formula (start of section 2) as follows:-

$$TU_t = TU_{t-1} \times \left( 1 + \frac{wSSP_r}{100} \right)$$

With following new definitions:-

$TU_t$  means the maximum theoretical charge the licensee may have charged for each premises had the ceiling  $C_t$  and floor  $F_t$  not applied subject to paragraph 2 of this condition in year 't'

$TU_{t-1}$  means the maximum theoretical charge the licensee may have charged for each premises had the ceiling  $C_t$  and floor  $F_t$  not applied subject to paragraph 2 of this condition in the year preceding year 't' or part thereof

**Choice of Options:** The source of the discrepancy is centred around how  $TC_{t-1}$  is calculated. Option 1's change in the definition would be a simple method to rectify this without the need to change the formula. However, Option 2 has the benefit of providing the calculation of the charge that would apply had the charge ceiling, or charge floor, not been applied. Consequently

this is a more effective change to the drafting, in that it makes the interpretation of the licence condition easier to follow.

### **Summary of Views**

In ESP's opinion:

- It is clear to ESP that the current methodology used to calculate the RPC charges does not properly follow the key principle of RPC, which is, that between the Floor and Ceiling, the charges should be "relative" to the equivalent GDN's charges.
- ESP cannot find the reasons given as to why the current methodology was chosen as the preferred basis for calculating future year's RPC charges. No explanation was given (in the Ofgem correspondence released at the time) as to why the Authority thought it more appropriate for the GDN and the iGT prices to have the potential to deviate from one another between the floor and ceiling. With the potential for the charges' to deviate from one another, the current methodology is clearly inferior to a methodology that reflects the intent of RPC.
- One of the principle reasons for introducing RPC was to ensure the all the way charges for iGTs networks did not exceed the equivalent GDNs' all the way charges, between the Floor and Ceiling. The current methodology allows this to happen. This would indicate that the discrepancy was not intentional and the true intention of RPC (as ESP has described throughout this document) was not properly translated into the RPC licence condition.
- Previously, and as part of the clarification of the guidance notes, a significant number of drafting errors have been identified in the RPC licence condition. Some are obvious mistakes, supporting the theory that final drafting of the RPC licence condition was not fully proofread. This adds credence to the conclusion that the discrepancy in methodology is due to a drafting error that was not identified in the final stages.

Consequently, ESP's believes that a change needs to be made the Transporters' Special Licence Condition 1 (either a clarification of original intent, or a change in the licence) to ensure the calculation of the RPC charges properly reflects, the true intentions of introducing RPC.