The Joint Office of Gas Transporters
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23 November 2009

By email only

ES PIPELINES

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Dear Sirs

Methodology for Determining the Balance of Revenue Recovery between LDZ System Charges and Customer Charges

I am writing to provide a response to your recent consultation DNPC05 on behalf of ES Pipelines Ltd ('ESP'). ESP is an independent Gas Transporter whose revenues are directly linked to the transportation charges of the regional upstream gas distribution networks.

The changes proposed in DNPC05 will affect ESP in three ways.

1. Impact on charges to new/future supply points

New network charges are set up according to the prevailing upstream transportation charges. Therefore, charges to new supply points entering RPC in April 2010 will be impacted immediately by the proposal.

The iGT's revenue is derived by subtracting the CSEP charge from the relevant LDZ system charge. Where the CSEP charge is increased, and the system charge lowered, there is a pronounced negative impact on the revenues remaining for the iGT. For smaller networks, this is the case in the majority of regions. The impact on larger networks is less pronounced overall, although we still see an average reduction in available revenues.

2. Impact on charges to existing RPC supply points

Charges to existing supply points will be affected after a time lag, through the changes to the wSSP figures. Because existing RPC prices have been locked down at the point of RPC entry, the proposed rebalancing exercise can only affect the annual (January) changes to these network charges.

However, any changes here will be masked by the fact that the vast majority of existing RPC prices across all regions has hit the ceiling, which exists to cushion iGT prices from the effect of large variations in DN prices.

The ceiling has a significant affect on iGT transportation charges. Over a period of a number of years, DN charges have seen a relatively steep rise; however, the equivalent locked down RPC price has not tracked this rise, since doing so would have taken that price above the ceiling. The net effect of this is a combined all the way transportation charge to a shipper on an iGT supply point which is *lower* than it would be on a DN network.

However, that is not to say that in principal such a rebalancing exercise will never impact iGT revenues. It is an accident of circumstance that it would not generally do so on this occasion. Bear in mind also that future price changes are based on a baseline RPC charge level, not the actual price charged (which could be the floor or ceiling level). Therefore, historical adjustments are never lost, whether or not they affect the actual RPC transportation charge at the time of the change.

But what cannot be overlooked in any case is the impact of this proposal for iGT shippers. A shipper with customers on an ESP network will be adversely affected by the current proposal because its bill is made up of two parts: the iGT invoice (which is likely to remain unchanged due to the ceiling), and the CSEP invoice (which will increase as a result of the proposal). On a DN network, that same shipper would benefit from the netting off of the changes to the customer and system charges. For the iGT network, such a netting off does not take place, since because it has been locked down, the iGT charge does not see a direct equivalent reduction.

Two points can be made in summary:

- The effect of this proposal on existing iGT charges will be limited due to the particular circumstances of the ceiling and level of increase over and above the ceiling that DN charges have undergone in recent years;
- It will be shippers, not iGTs, who are adversely impacted in this area. Their iGT charges will remain unaffected, but their invoice from the upstream transporter will in most cases be higher, meaning rising total bills.

This is illustrated in ESP's response to DNPC04.

3. Impact on existing legacy supply points

ESP's networks whose revenues are governed by legacy charging arrangements are not directly affected by the proposal. No new networks are constructed under these charging arrangements, and their prices change by inflation rather than being linked to those of the upstream transporter(s).

However, these networks are due to migrate to RPC charging arrangements over the coming several years. This migration date was calculated to be the point of revenue neutrality i.e. the date where projected future income matches what would be foregone in leaving the legacy charging arrangements behind. There are two distinct impacts to discuss, depending on when a network is due to move from legacy to RPC arrangements.

Those networks migrating *before* 2014 will not be subject to a recalculation of migration dates/prices. This means that upon migration, the RPC price level for these networks will be higher than other networks entering RPC at the same time. And so a tier of 'legacy RPC' charges will be created, adding uncertainty and complexity for shippers instead of the intended added simplicity.

For networks due to migrate *after* 2014, a further round of assessment is due to take place to confirm revenue neutrality dates. In understanding that these networks will effectively be treated as brand new RPC networks, the reduction in available revenues discussed in section 1 (above) will apply. With these revenues being lower than expected, it is valid to question whether such networks must remain under legacy arrangements for longer, as the point of revenue neutrality will have been pushed further into the future than would have been the case.

These effects are illustrated in ESP's response to DNCP04 which I attach to this letter for your reference.

Response to consultation questions

1. It would seem sensible to assume a DN specific split of costs in order to promote increased cost reflectivity.

2. A rebalancing exercise should be based on average data. We have concerns as to whether the proposed average of two years' data is sufficient when standard regulatory practice takes a five-year view. The variation between 07/08 and 08/09 data bears out these concerns: a further year's data could have a significant impact on the balance of charges and so it is unfortunate that there is not a longer history of data to draw from.

3. Yes. If a review of the balance of customer and system charges is to take place periodically, then ESP would be supportive of this being linked to the price control cycle, rather than on an ad-hoc basis. This view holds for this initial rebalancing exercise also.

4. Bearing in mind the impact that ESP's analysis identifies above, it is appropriate to ask whether a competition test has been carried out on the proposed changes. It is of some concern that the proposal suggests a neutral impact on average for iGTs when it is clear that in all regions bar one there is a reduction in the margins available to iGTs.

   ESP agrees with DN views on charging methodology objectives (a) and (b). We question the view on objective (c) (facilitating competition), in that whilst the proposal creates greater certainty that the balance of charges will change (and when), it does not provide greater certainty of actual charges as such (and therefore the impact of the change on gas suppliers and iGTs).

   We are forced to conclude that the proposal should not be implemented in April 2010.

Summary

A number of impacts of the proposal are discussed in this response:

- On new and future networks, ESP would enjoy generally lower margins. This margin squeeze is most evident on smallest networks.
- For existing networks, the changes proposed would impact ESP's charges, but for the existence of the ceiling for RPC charge amendments. But this does lead to an increase in the shipper's overall transportation bill. ESP would not want this to lead to an unjustified negative perception of iGTs.
- Changes to expected levels of RPC charges affects the smooth transition away from legacy migration arrangements, creating confusion for shippers and potentially further work for iGTs and Ofgem.

ESP's assessment of these impacts means that whilst we are sympathetic to the proposed region-specific balance, and the suggestions for periodic review of this balance, the overall negative impact on the level of revenues (and hence margins) available to ESP means that we are unable to give support to the proposal.

Yours faithfully

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4 November 2008

By email only

Dear Sirs

RE: DN PRICING CONSULTATION PAPER DNPC04

Introduction

ES Pipelines ('ESP') is an independent gas transporter operating networks in every Distribution Network area. Changes to the balance, level or structure of DN charges have direct impact on iGTs because of our link to those charges under Relative Price Control.

ESP considers that a number of unintended consequences relating to Relative Price Control (RPC) have not been considered by the DNPC04 consultation. These consequences have a significant impact on iGTs and shippers and can be understood in three distinct areas:

•The effects for future RPC supply points
•The effects for existing RPC supply points
•The effects for the migration of legacy supply points to the RPC regime

This response illustrates these three areas before addressing the specific questions asked in the consultation paper. This response is made on behalf of all licensed gas transporters within the ESP Gas Group, all of which will be referred to as 'ESP'.

1. The effects of the proposal for future RPC supply points

The customer charge often makes up a significant proportion of the total RPC charge earned by the iGT. For very small networks, it makes up 100% of the iGT's transportation income. Intuitively, a rebalancing away from customer charges towards system charges would lead to a reduction in iGT income for an equivalent supply point.

Note: all figures below use illustrative charges to illustrate the principles discussed. They could however be considered indicative of the effects in certain DN areas, according to initial analysis.

Figure 1 shows the reduction in the potential RPC price with a rebalancing of £5 away from the customer charge towards the CSEP charge.

Figure 1

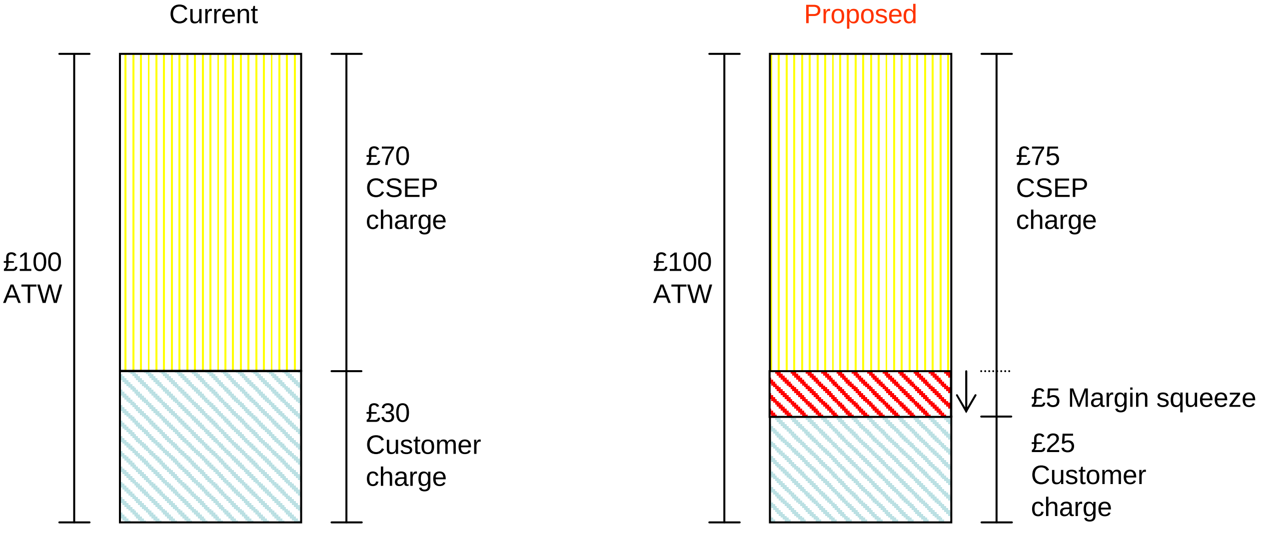
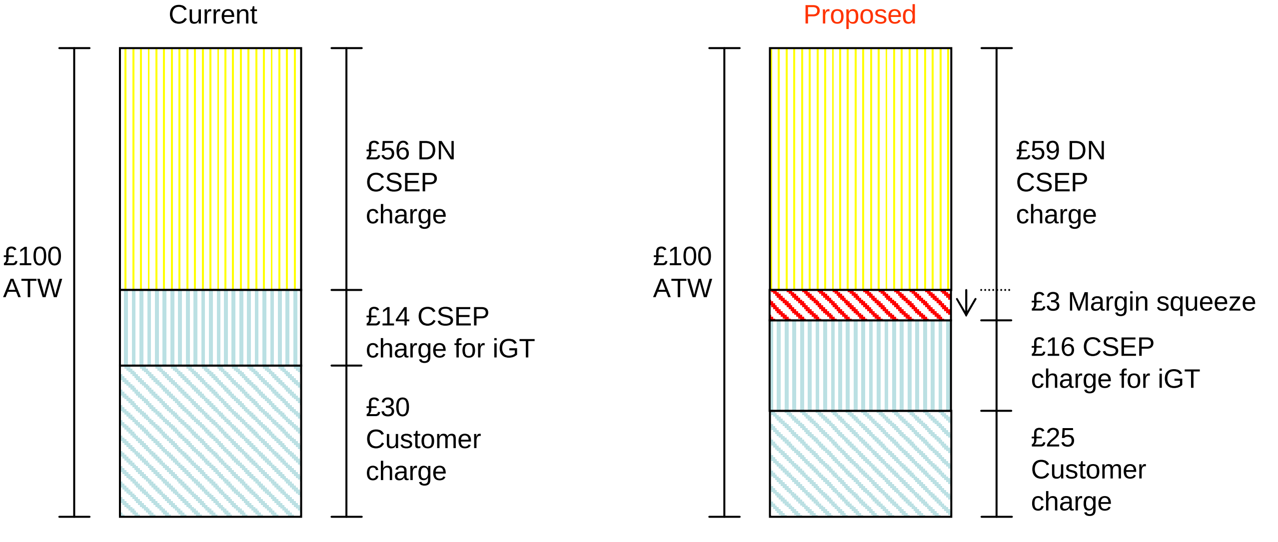


Figure 2 shows a similar but less marked reduction in the potential RPC price where the iGT benefits from a proportion of the CSEP charges in its RPC charge.

<u>Summary</u>
Consequence: Margin squeeze
Impact: High impact for iGTs; potential impact for whole market (may contravene competition law)

Figure 2

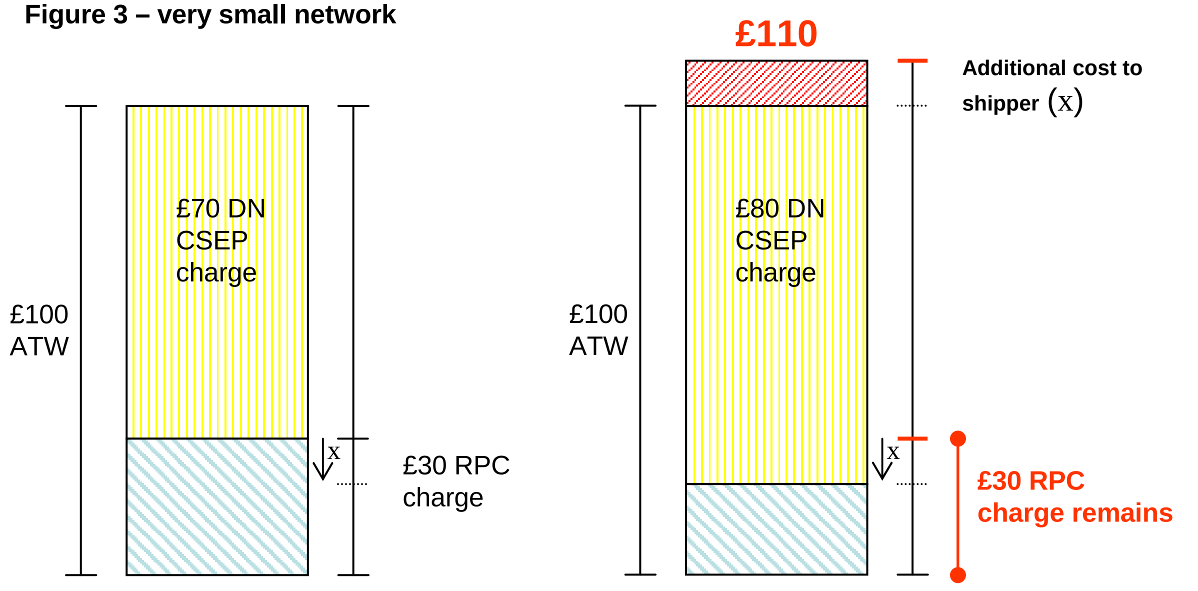


ESP considers that there is significant potential for the proposed rebalancing to lead to margin squeeze, leaving us less able to compete for connections against the incumbent DN.
The potential existence of margin squeeze has implications for competition in the market for gas connections
The most marked impact will be on very small networks in those areas where the customer charge is being reduced the most. With larger networks, the RPC income available does not fall by the whole customer charge reduction, as a proportion (but never all of it) is recouped through the CSEP charge.

2. <u>The effects of the proposal for existing RPC supply points</u>

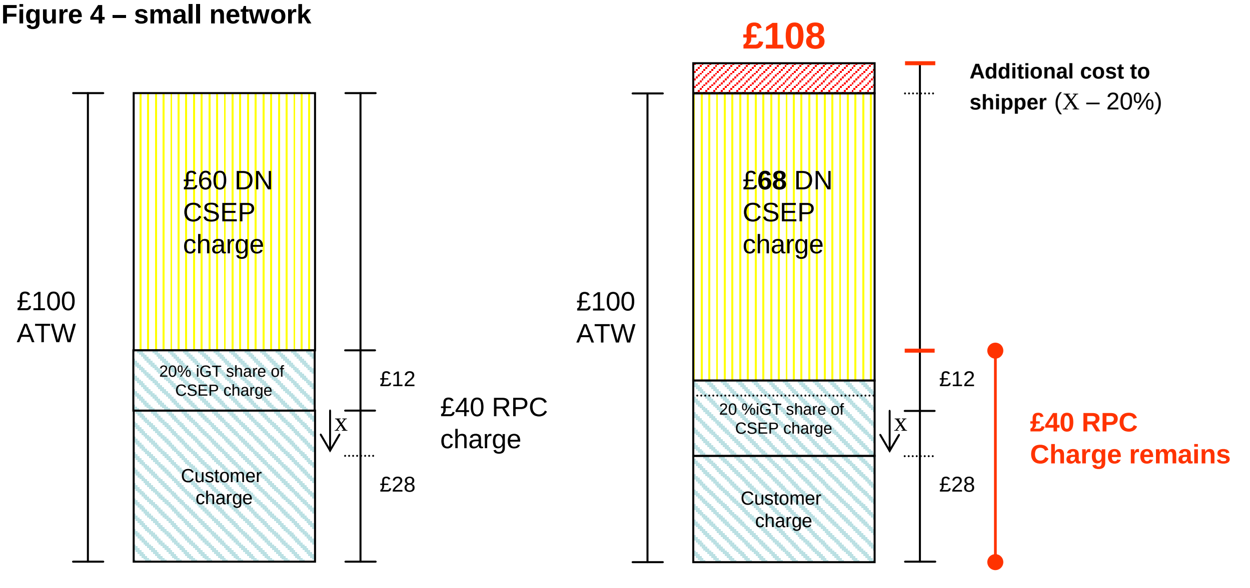
The proposal would lead to the creation of a price differential between existing iGT RPC supply points and supply points that are directly connected to the host DN. This is what RPC seeks to avoid. The additional cost would be borne by the shipper on the RPC supply point. The issue is caused by the simple fact that the RPC price for existing supply points is locked at its level at the time the network was built, and <u>will not</u> change as a result of this proposal, whereas the DN's proportion of the total transportation charge (as per the shipper's 'CSEP invoice') changes month on month according to the prevailing charging methodology.

Figure 3 – very small network



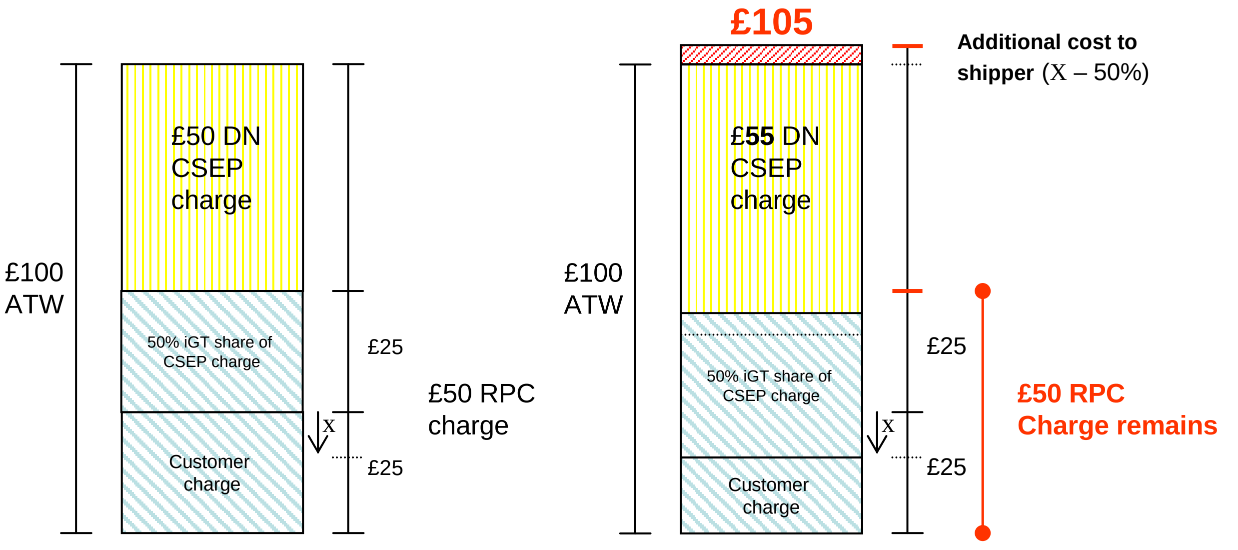
An illustrative drop of £10 in the customer charge leads to an increase of £10 per supply point for the total transportation charge, because the iGT continues to charge £30, at the same time as the CSEP charge is 'stretched' to fill the gap left by the reduced customer charge.

Figure 4 – small network



The RPC price includes a 20% share of the CSEP charges. In Fig. 4(b) the iGT would be entitled to 20% of the increase in CSEP charge, so the new DN charge is not as large as it would have been. 80% of the 'stretch' is paid in additional cost by the shipper.

Figure 5 – large network



The RPC price includes a 50% share of the CSEP charges. In Fig. 5(b) the iGT would be entitled to 50% of the increase in CSEP charge, so the new DN charge is a lower proportion of the total than would have been the case. 50% of the 'stretch' is now paid in additional transportation charge by the shipper.

Summary

Consequence: Increased transportation costs to existing RPC supply points. Regardless of the size of network, the shipper will always pay a higher transportation charge, with a more marked impact for smaller and domestic networks.
Impact: High cost impact for shippers; high impact to customers if the shipper passes the additional costs on; medium impact for iGTs as negative perception by shippers and potential justification for the iGT surcharge.

Could this be avoided?

ESP is in no position to dispute the validity of the new percentage allocations to the customer charge, and has no issue with the requirement for cost reflectivity that DNs are seeking to adhere to. But is clear that the proposed change has some significant impacts that have not been explored in the consultation. It may be possible to avoid these consequences by ensuring that the resulting RPC price matches its previous level. If less of the RPC price is made up of customer charges, then a correspondingly higher proportion needs to be recovered through the CSEP (system) charge. This would involve a change to the CSEP charge equation to maintain the current level of recovery that the DN makes through the CSEP charge. The RPC price would remain the same, with the iGT recovering more from the CSEP charge than is currently the case. The split between RPC and DN charges would remain unchanged, and shippers would see no difference in their total transportation charge.

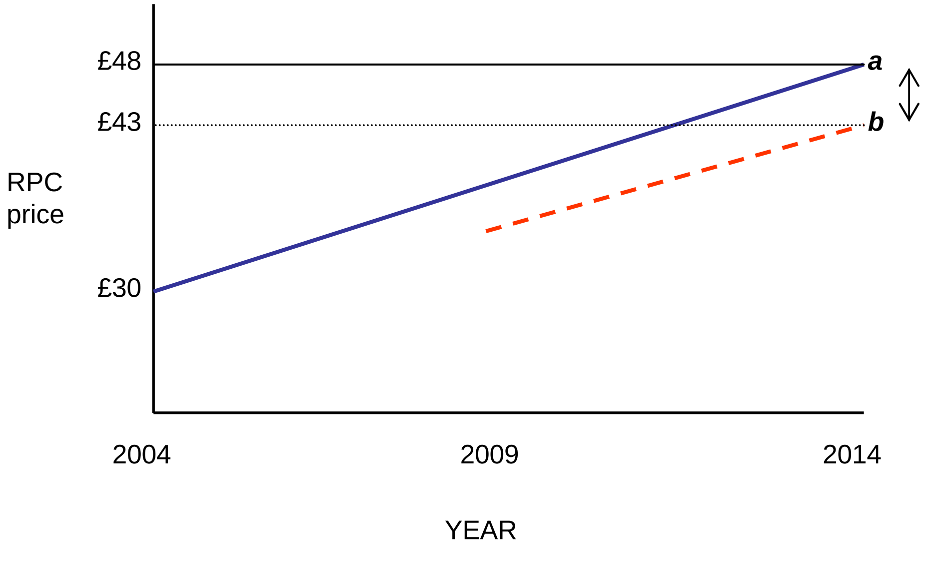
3. The effects of the proposal for the migration of legacy supply points

At the introduction of RPC, it was not possible for existing iGT networks to enter the RPC regime immediately, due to the basis upon which the capital had been invested in those networks, and the expected return on that capital. It was agreed in 2004 that these networks would continue to be priced on a 'legacy' basis until such a time as the iGT became 'revenue neutral' and would see no detriment in switching pricing to an RPC basis. At the same time, shippers would be able to treat the two sets of supply points the same because the previous price differential will no longer exist. ESP's three legacy portfolios are due to migrate in 2015 and 2018. Sites migrating to RPC before 2014 will migrate at shadow prices i.e. locked in at 2004 assumptions. Sites migrating after 2014 will migrate at the prevailing RPC price. This leads to two potential consequences.

3a. Legacy sites migrating before 2014

A reduction in the RPC price now will result in a lower future RPC price than anticipated in 2004. Figure 6 shows this effect. Legacy supply points will migrate with an RPC price of £48 (point ***a***), based on the projected 2004 price. The prevailing price curve for new RPC sites will have changed from 2009 (as per current proposal), meaning that there is a marked differential between sites migrated and sites set up in 2014. This was not the understanding at the time that legacy migration was agreed.

Figure 6



Summary

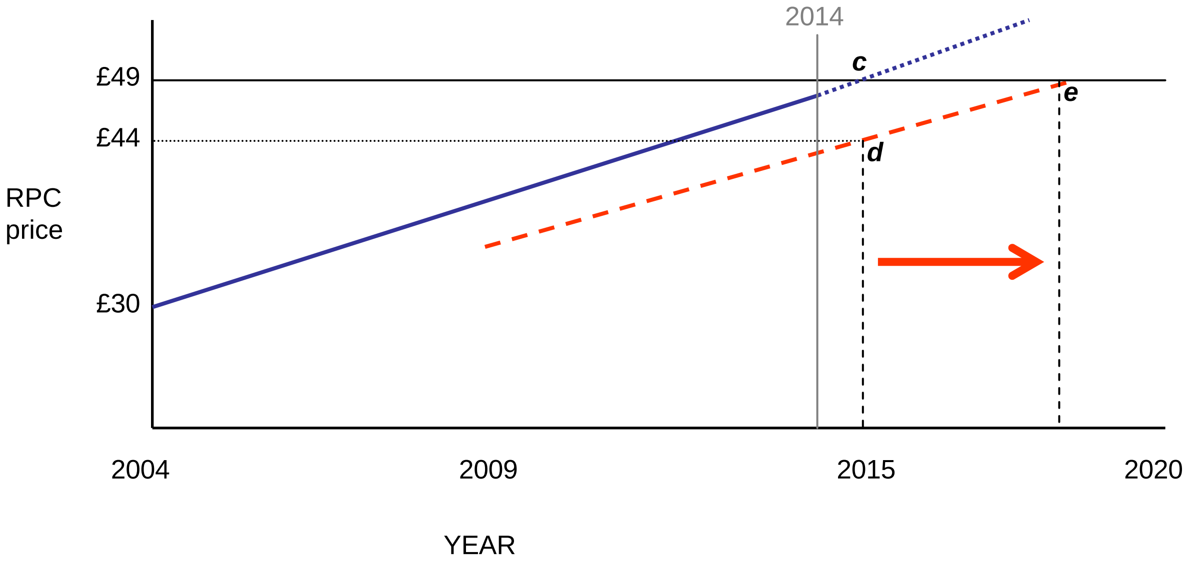
Consequence: Legacy supply points will migrate to RPC at a price significantly higher than the prevailing RPC price, essentially becoming 'legacy RPC' supply points. The existing issue of the differential between legacy and RPC prices will still exist, and shippers may be forced to continue to treat the two sets of supply points differently.

Impact: Shippers; iGTs due to potential for continued or increased iGT surcharge levied by shippers

3b. Legacy sites migrating after 2014

A reduction in the RPC price now will result in a lower future RPC price than anticipated in 2004. Figure 7 illustrates a 2015 migration to a price ***d***, £5 lower than the projected point of revenue neutrality at ***c***. The migration date is pushed out to point ***e*** if the iGT were to wait until the equivalent to point ***c*** is reached on the prevailing RPC curve.

Figure 7



Summary
Consequence: The expected migration price will be higher than the actual migration price after 2014. If iGTs take the opportunity to review the situation in 2014, this could lead to an adjustment of migration dates further into the future.
Impact: Shippers; iGTs

Response to consultation questions

Question 1: Should the balance of customer charges in the charging methodology be network-specific?
ESP would prefer that a weighted average were used in order to minimise complexity and the potential for DN-specific changes to the balance of charges in the future.

Question 2: Should there be a rebalancing each time the level of charges change, or should there be a threshold change level set?
ESP believes that the it would be appropriate to set a threshold level to maintain a degree of short- to medium-term stability, but has no views on the level of this threshold. In answering this question, DNs are advised to consider the materiality of the change against the cost of implementing the change for all affected parties.

Question 3: Is there any reason why the proposal should not be implemented from 1st April 2009?
ESP opposes the implementation of this change in April 2009. This response highlights number of areas that have not been considered by the consultation. There has not been sufficient time to conduct a full impact analysis, or to explore alternative/additional measures to counterbalance the negative impacts identified. It has been indicated that further work in this area may be on the horizon, for implementation in April 2010. ESP would prefer that the current proposal is considered in conjunction with other related changes, and would be pleased to provide input into any such consultation.

General comments

In conclusion, ESP considers it unfortunate that there has been little time to understand the full impact of this proposal. There have however been identified a number of potentially significant impacts for iGTs and shippers which are not considered in the consultation paper. ESP would have expected an upstream provider in a dominant position to have carried out a full impact analysis for all of its customer groups and feels that IGTs have been overlooked in this case.

ESP urges the proposer(s) to consider delaying further stages of this proposal to allow for an assessment of further RPC-related analysis, and the inclusion of other related areas of work.

Please do not hesitate in contacting me if you would like to discuss this response further.

Yours faithfully

David Speake
ES Pipelines Ltd.