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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

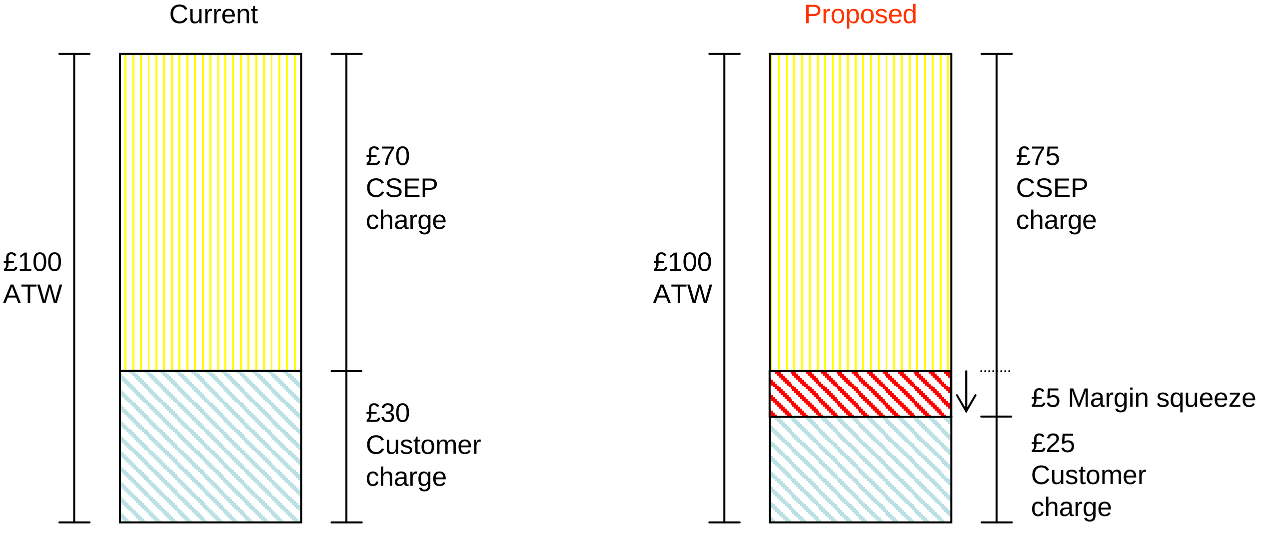
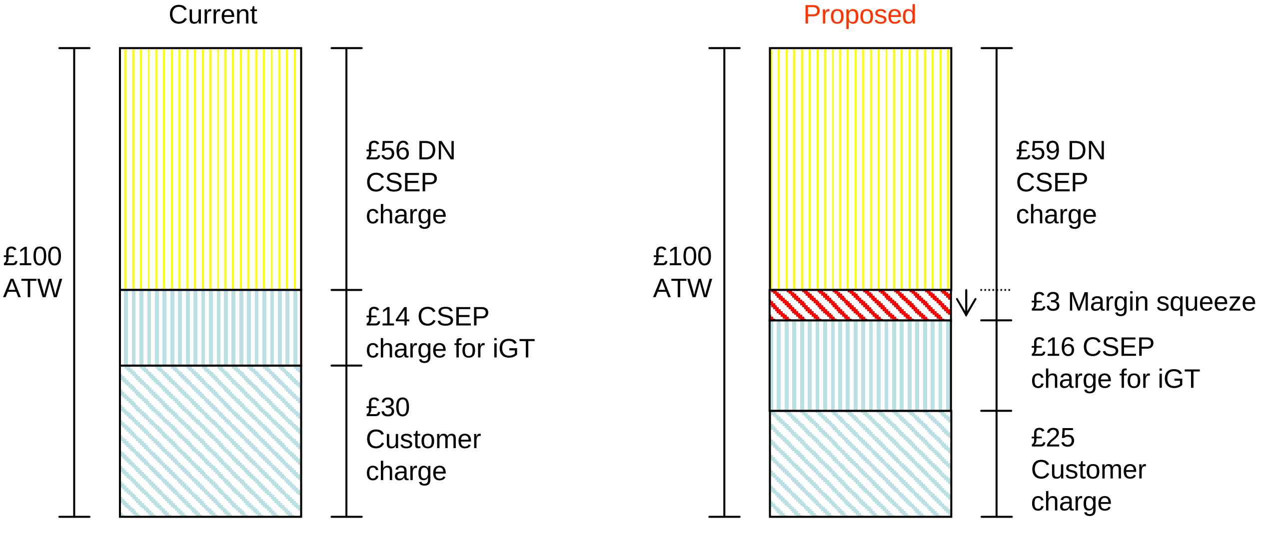


Figure 2 shows a similar but less marked reduction in the potential RPC price where the iGT benefits from a proportion of the CSEP charges in its RPC charge.

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

Figure 2

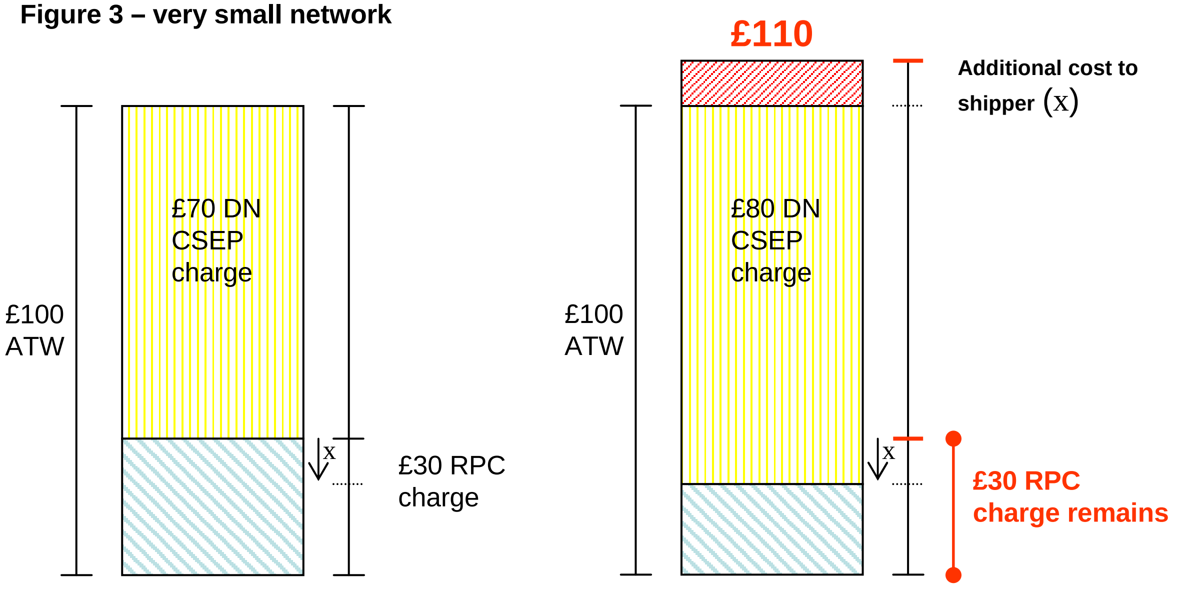


ESP considers that there is significant potential for the proposed rebalancing to lead to margin squeeze, leaving us less able to compete for connections against the incumbent DN.
The potential existence of margin squeeze has implications for competition in the market for gas connections
The most marked 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. The effects of the proposal for existing RPC supply points

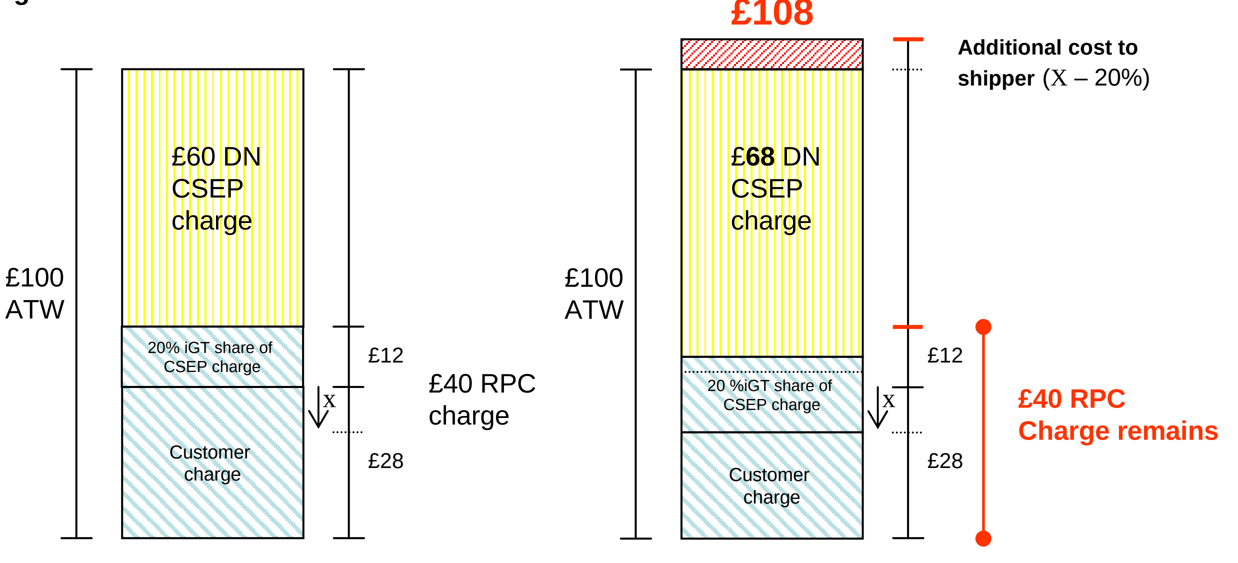
The proposal would lead to the creation of a price differential between existing iGT RPC supply points and supply points that are directly connected to the host DN. This is what RPC seeks to avoid. The additional cost would be borne by the shipper on the RPC supply point. The issue is caused by the simple fact that the RPC price for existing supply points is locked at its level at the time the network was built, and will not 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



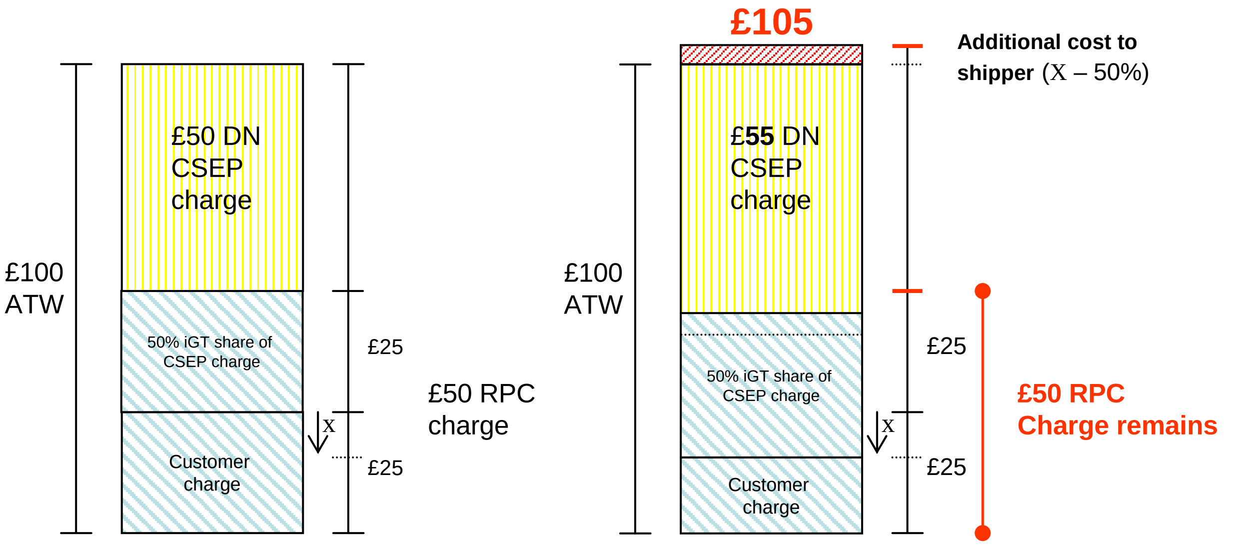
An illustrative drop of £10 in the customer charge leads to an increase of £10 per supply point for the total transportation charge, because the iGT continues to charge £30, at the same time as the CSEP charge is 'stretched' to fill the gap left by the reduced customer charge.

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.

<u>Summary</u>

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.

<u>Could this be avoided?</u>

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.

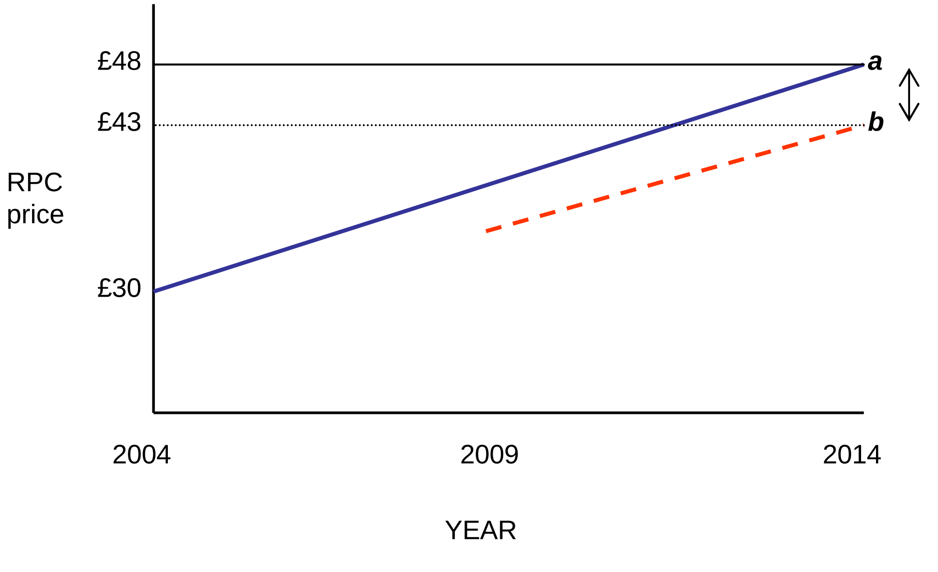
3. The effects of the proposal for the migration of legacy supply points

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

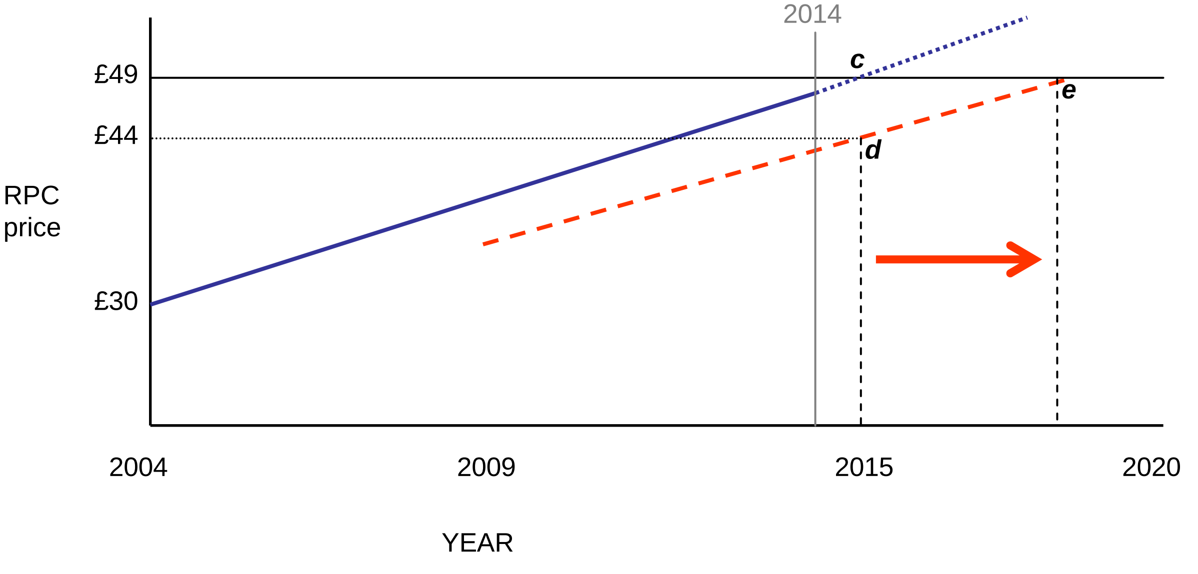


Summary
Consequence: Legacy supply points will migrate to RPC at a price significantly higher than the prevailing RPC price, essentially becoming ‘legacy RPC’ supply points. The existing issue of the differential between legacy and RPC prices will still exist, and shippers may be forced to continue to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