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*calls will be recorded and may be monitored

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Date 1st March 2006
Our Reference
Your Reference

Re: Modification Proposal 0073 – Revision to the Notice Period regarding the implementation of changes to Transportation Charges

Dear Julian,

Thank for your invitation seeking representation with respect to the above Modification Proposal. National Grid Gas Distribution (National Grid) does not support implementation as it would create instability into the charging regime, exacerbating the problems highlighted by Suppliers. The Modification Proposal should not be adopted because it fails to further the relevant licence objectives of:

A11.1 (d) The securing of efficient competition between relevant shippers, suppliers and DN operators, and;

A11.1 (c) …the efficient discharge of the licensee's obligations…

Overview

National Grid agrees with the proposer's comment, where it states that "Inaccurate transportation charges impact the structure of the competitive market and can distort the final prices paid by customers to the detriment of the market as a whole." The practicalities of the proposed modification would have the opposite effect to that desired by the proposer. National Grid has suggested an alternative solution, which would eliminate the issues that Suppliers are experiencing whilst maintaining the integrity of the charges set.

Incomplete Information

Setting of accurate charges requires Transporters to have timely data available to calculate charges. Appendix 1 illustrates, the schedule for setting charges has been developed to ensure that the Transporter has the most up to date information relating to the previous year and latest forecasts for the next period, when determining the charges. Bringing the setting of charges forward, in line with the proposal would require prices to be set without a

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full picture of the over or under recovery (DNK)[1] for the year that has been completed and without an up to date forecast of the

[1] Gas Transporter Licence (Distribution) Special Condition E2B

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Mains Replacement Incentive position for the following year (DNMRA). Under the proposed timetable, DNMRA and hence DNK carried forward would not have been established.

Appendix 1 also shows that the volume forecast data is updated prior to charge setting under the current regime. The volume data is critical in establishing the forecast allowed revenue and forecast collected revenue for the following period. Under the proposed timetable, the volume forecast would be available too late to enable National Grid to be able to factor it into charges for the 1st June. This data is provided to the Distribution Networks (DNs) by National Grid Gas Transmission in mid-May, and DNs are not able to access such information earlier.

The effect of incomplete information is demonstrated when looking at the indicative charges for 2005/6 which were established with equivalent data to that that would be available if the proposed modification were adopted. If National Grid had applied the indicative charges, the latest DNK values for March 2006 would have been materially larger for all of the networks, with DNK for London exceeding 4% of allowed revenue (over-recovery). This is clearly inconsistent with licence requirements that charges should be cost reflective and that the Transporter should not aim to over recover in a period, since National Grid knew by July that the indicative charges would over-recover.

The proposer also makes reference to the need for the charges to be accurate as the DN charges become more disparate over time. Whilst it is true that prices are likely to diverge over time, this is not a factor within the proposed modification. Each DN has its own price control and maximum allowed revenue and all calculations of charges are performed on a network basis. Bringing the setting of prices forward would not directly impact upon the divergence of prices between networks.

<u>Charges Volatility</u>

A further complication of the Proposal, which is a function of the incomplete information outlined above, is that the subsequent price changes which are required in the following periods are likely to be larger because the DNK values carried forward from the previous year would be greater. This volatility would continue into future periods as each inaccurate charge setting would require a large change to correct for the previous over or under recovery. Such fluctuations would not serve the market efficiently because the greater variability would hinder the customers' ability to effectively compare prices.

A potential impact of this volatility could be the Transporter being duty bound by Licence obligations to amend prices more than once a year to ensure that there was not significant over recovery. This would further exacerbate the issues that Suppliers are facing by further reducing the predictability of charges.

Whilst National Grid acknowledges any variability in prices may cause Suppliers difficulties, the proposed modification is likely to introduce more inaccurate charges and amplify the fluctuations between years.

Customers who seek to actively partake in the market to ensure that they secure the best deal, require a market where direct comparisons can be made between contracts, between Shippers, and between periods. Whilst established charges for the first year may help Suppliers set prices in the first year, the subsequent volatility would make the ongoing

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comparability of prices much more difficult, which is detrimental to an efficient market. National Grid believes that this issue could be resolved by the Supplier and the customer agreeing to delay the setting of a new contract by as little as one month after 1st October. This would allow the Transporter to set accurate prices and give both the Supplier and the customer ample time and full visibility of the transportation charges during the contract negotiation period.

Customers who do not actively partake in the market would also suffer where prices fluctuate more significantly. Within its Modification Proposal, the proposer acknowledges that any increase in transportation charges would be passed on to the customer. Whilst this is appropriate when the Supplier's costs are increasing, it is possible that a Supplier would not pass on benefit when the transportation charges fall, when the Supplier has a customer who does not actively consider alternative Suppliers. As a result, any increase in the magnitude in the change to transportation charges, as we predict under the modification, would be likely to be detrimental to the customer and the efficiency of the supply market.

Alternative Solutions

Suppliers are not restricted to making changes to their charges. Suppliers with variable charge contracts are able to amend their charges as and when required and so would not benefit from the proposal.

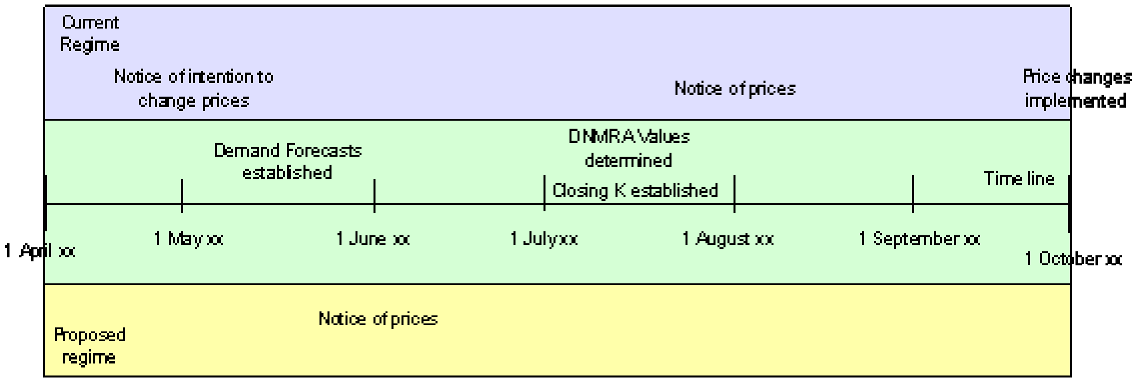
Where a Supplier enters into a fixed price contract, National Grid considers that there is a simpler, more effective solution to the issue of uncertain charges, which is in the remit of the Supplier, would not require modification of the UNC and would maintain accurate prices and give all parties full visibility of their charges for a greater part of the year than present. By extending current contracts so that new contracts do not start until the charges have been finalised, Suppliers would allow the current pricing schedule to be maintained, with the benefits of accurate prices that that brings while also eliminating the issues that the Suppliers are experiencing. Delaying the start of a new contract would give the Supplier full visibility of the transportation charges for 11 months of a 12 month contract.

Please contact Chris Warner on 01926 653541 (chris.warner@uk.ngrid.com) should you require any further information with respect to the above representation.

Yours sincerely,

Declan McLaughlin
Commercial Manager – Customer Service
National Grid

Appendix A


Current Regime
Notice of intention to change prices
Notice of prices
Price changes implemented
Demand Forecasts established
DNMRA Values determined
Closing K established
Time line
1 April xx
1 May xx
1 June xx
1 July xx
1 August xx
1 September xx
1 October xx
Notice of prices
Proposed regime