Industry & Regulation
3 The Square
Stockley Park
Uxbridge
Middlesex
UB11 1BN

Direct Dial: 0208 734 9353
Facsimile: 0208 734 9350

Friday, 31 August 2007

Tim Davis
Joint Office of Gas Transporters
Ground Floor Red
51 Homer Road
Solihull
West Midlands
B91 3QJ

By E-mail: Enquiries@gasgovernance.com

Dear Tim,

Re: DNPC03 – LDZ System charges – Capacity/Commodity Split and Interruptible Discounts. A Consultation Paper on behalf of all Distribution Networks

This response is on behalf Centrica plc excluding Centrica Storage Ltd; the response is non confidential.

As with PDDN02, we note the questions raised within the consultation, but we consider that the consultation raises additional concerns, which we have addressed first.

Overall, Centrica does not support the introduction of these proposals.

1. Nature of the proposals
The proposals contained within this consultation document appear to match the proposals contained within PDDN02. In view of the clear concerns expressed by a number of respondents to the document, we consider it is unfortunate that more weight has not been given to respondents' views, which appear to have been largely discounted by the GDNs.

2. Information provision
We acknowledge that some information has been provided with the consultation, but note that this is still at an aggregate level, and that it does not include indicative price changes. As well as being at an aggregate level, the indicative impacts are given only on an average basis by load band. When providing average data, the GDNs should provide analysis showing the

standard deviation of the change in charges by load band, together with the maximum and minimum change and the distribution of customers affected across the range of impacts.

Further information was provided at the DCMF meeting of 13th August 2007. Whilst we welcome the attempts by the GDNs to provide more data, drip feeding information to respondents part way through a consultation period is, in our view, poor practice and undesirable. This should have been provided in the consultation document. We have carried out some calculations using both sets of data provided (the factors to be applied to the charges and the averages by load band), and have noted some significant discrepancies between the two sets of results. We are also not persuaded that the impact is limited to £1 per customer.

The poor approach to data reduces our ability to evaluate the proposals which in turn, limits our confidence in the results and strengthens our opposition to the proposals.

3. Variation between GDNs

There appears to be a significant degree of variation in the impacts between GDNs which has not been explained. GDNs have commented that adverse effects will generally impact lower load factor (mainly domestic) customers. However, it does not appear to be as straightforward as a simple comparison of load factors, at least in so far as the changes are applied to Domestic customers.

4. Customer Implications

In terms of the overall effects of these proposals, in combination with the change to customer charges in April 2007, the result would be Gas Distribution charges which are based 96.5% on capacity. The current 50:50 capacity to commodity split is considered arbitrary: however we believe that basing charges 96.5% on capacity is equally arbitrary. We do not consider that there is any better argument for allocating indirect costs such as overheads on a purely capacity basis than there is for sharing them 50:50 on a capacity/commodity basis.

GDNs assert that these proposals will not introduce fixed charges for gas suppliers/suppliers as the charges will still be based on the size of the domestic supply point. The GDNs further state that there is, therefore, no reason why the change should result in the introduction of standing charges by gas suppliers. Centrica considers these comments to be overly simplistic. Whilst it is true capacity is not “fixed” per se, it will only change when the AQs are reviewed and will not reflect demand profiles; hence relative to commodity it can be considered “fixed”. Whilst wholesale costs do outweigh distribution costs in customers’ bills, the proportion of costs associated with distribution is still significant.

As stated above, the proposed change will adversely impact low load factor customers and benefit high load factor customers, which is of particular concern. Thus, if suppliers consider that the changes require tariff changes to apply a standing charge, this could be expected to adversely affect lower consuming customers; which could include a number of fuel poor and vulnerable customers.

A high proportion of fixed charging would impact energy efficiency incentives and conflict with the green agenda. Changes to the AQ will lag actual consumption changes by at least a year, further reducing the correlation between customer behaviour and charges.

5. Timing

We note paragraph 5 in section 5, implementation of change, and would like a further explanation of its contents, with a financial analysis of the expected impact as we believe the drafting is unclear. We will comment further on the timing of the change once this analysis has been supplied and in the interim reserve our view.

We have previously stated that if, notwithstanding opposition, the proposals were to be implemented, they should not be implemented in advance of full interruptions reform. We continue to hold this view.

6. Information transparency

In respect of the charges received, suppliers value simplicity, predictability and transparency. We agree these proposals would be expected to lead to greater stability <u>within</u> charging periods; however, this may well not be the case <u>across</u> charging periods. Hence, without significantly more transparency and predictability in respect of future periods than currently exists, such stability has limited value.

GDNs have not recognised this point, and as a result have failed to include proposals in this consultation document which might improve these issues for suppliers. Centrica continues to believe that the main advantages from these proposals would accrue to the GDNs as a result of a transfer of risk from GDNs to customers via suppliers, which we strongly oppose in the absence of significant compensation to customers.

7. Price control impacts

In conjunction with the removal of the volume driver from the price control, these proposals would relieve the GDNs of their volume risk and hence reduce over or under-recoveries against allowed revenue (i.e. K). However, we would expect a (smaller) K to remain, and believe that there may be an additional risk to low load factor customers in this area. Based on our understanding of processes, K (+/-) is added to allowed revenue in the succeeding year. This amended allowed revenue is then translated into charges using the charging methodology. Given the source of the under-recovery is not distinguished, and as noted by the GDNs, these proposals will adversely impact low load factor customers, we believe there to be a real risk that future under/over recoveries will be inappropriately targeted to low load factor (usually domestic) customers. This would be inequitable and should not be permitted.

If, in spite of the important concerns and opposition raised in responses, these proposals were to be implemented, we would expect a consequent demonstrable reduction to the allowed Rate of Return, in order to recognise this significant transfer of risk from GDNs to suppliers and hence customers.

8. Link to Licence Modification proposals

If the volume driver is removed from the price control, and the changes proposed in this consultation were implemented, leading to a reduced K and GDNs' expectation of reduced variability in charges, we cannot see why GDNs should also need to change prices twice per year. We will be responding to the separate licence consultation in due course.

However, if the both changes are implemented, and hence future charging becomes capacity based, we believe that the major change should be gas year aligned i.e. October, as now, with the implementation of the new AQs/SOQs. As GDNs have previously commented on the difficulty of establishing accurate charges in advance of the end of the formula year, we consider this should be more practical in all respects.

We would also note that if the major changes are applied in April, suppliers will experience a further significant change in charges in October even in the absence of a further notification to reflect the implementation of the new AQs and SOQs.

In terms of the specific questions raised:

a) Should the Charging Methodology be changed so that the capacity element of the LDZ System charges is set to recover 95% of the revenue from the LDZ system charges, and the commodity element is set to recover 5% of the revenue compared with the current 50:50 target split?

Overall, Centrica does not favour changing the Charging Methodology to a 95:5 split, we are not persuaded that this has been proven any more correct than the current 50:50 split. Please refer to out comments above.

However, if the change is made, we consider that the reduction in GDNs' risk must be reflected in the price control in terms of a substantial reduction in the cost of capital.

b) Should Interruptible supply points pay 47.37% of the increased LDZ capacity charge so as to maintain the value of the discount received by interruptible supply points at its current level on average?

As per our response to the previous pricing discussion paper, Centrica does not favour implementation of these proposals.

However, if such changes are to be made despite opposition, they would be better executed when the main reform of interruption takes place in 2011. Equally, we strongly oppose reductions in charges to interruptible supplies at the expense of Domestic customers.

In our view there is not enough information in the consultation document to enable suppliers to confirm that the GDNs have appropriately calculated an equivalent figure and hence we cannot judge whether 47.37% is correct or not. According to the consultation, this is an average figure and so meaningless without the standard deviation/range of impacts. Given the adverse impact on domestic customers, more detail is needed. Consideration should be given to replicating properly the monetary amount of the existing charges rather than applying an average adjustment which will not generate any "correct" charges.

c) Should this change be made with effect from 1st April 2008 or 1st October 2008?
Further to our comments above, whilst we do not support the change, if the change is to be made, we believe it should be implemented to align with the Gas year/AQ year rather than the formula year, hence October.

Whilst we do not support the implementation of these proposals and trust that Ofgem will veto them, we hope these detailed comments have been useful, but should the GDNs wish to discuss any points in more detail, I should be happy to help.

Kind regards,

Yours sincerely,

By e-mail

Alison Russell
Senior Regulation Manager, Upstream Energy

Centrica plc
Registered in England No. 3033654
Registered Office
Millstream, Maidenhead Road
Windsor, Berkshire SL4 5GD