Ofgem Review of Transco's Structure of Distribution Charges - Consultation Document

Comments from the Association of Electricity Producers

18 June 2004

The Association welcomes this review of distribution charges, but is concerned that it has been published at least five months later than planned and at a time when the industry is awash with the current flood of consultations from Ofgem on both gas and electricity issues. This means that industry resources are being severely stretched and it is very difficult for sufficient resources to be directed to all these issues simultaneously. We suggest that Ofgem should be more transparent about the way in which it prioritises its workload and consider the impact of con-current consultation periods when issuing consultations and setting the timescale for responses.

However, the Association agrees that it is important to consider any outstanding issues concerning the structure of distribution charges as part of any possible sale and we would welcome clarification of how this fits into the implementation plan and how this ranks in terms of priority amongst other issues.

Below we provide comments on the issues highlighted by Ofgem

Cost Reflective Charges

The Association considers cost reflectivity to be an important principle in the establishment of transportation charges and that cost reflective charges are more efficient as customers bear the appropriate costs when deciding whether to connect to the network and to consume gas. We also note that it is important to balance complexity and practicality when setting transportation charges.

We do however recognise that if charges were set based on marginal costs then Transco would not recover its allowed revenue, since its marginal costs generally lie below its average costs, due to significant economies of scale. It is therefore important that any scaling or mark up of the marginal costs maintains the costs reflective properties of the charges.

We note that the review of LDZ charging arrangements in 2000 did not recommend any move away from the current averaging approach to setting charges largely because of the administrative costs involved, although the benefits of increased cost reflective charging were recognised. At the time we noted that the proposed charging functions did not seem to fit the data particularly well for very large loads, and given that very large loads connected within the distribution network are relatively few in number it is difficult to be confident that the current algorithms actually result in charges that are in any way representative of the amount of the network used by such loads and are therefore cost reflective. We would therefore recommend that this issue in particular is reviewed to check that Transco is complying with its licence requirements.

With respect to the treatment of charges to CSEP's, the Association did not support the introduction of separate charging functions for CSEPs in 2000, and remains opposed this. We consider that loads of similar size connected to the same part of the network should pay the same charges and that any other approach gives rise to undue discrimination and creates unjustified cross subsidies. We therefore recommend that the separate charging function for CSEPs be removed.

We consider that the short haul tariff should be retained to avoid inefficient by-pass of the DN system. We also note that this tariff is only needed because the algorithms do not produce cost reflective charges for large sites. We also consider that going forward any reform to the NTS and DN exit arrangements should not further encourage by-pass of the DN or even encourage sites currently connected to the NTS to connect to the distribution network as maybe the case if universal firm capacity arrangements were introduced on the NTS only.

The Association would also like to suggest that customer charges are reviewed as these are disproportionately high for large sites and may not be reflective of the costs incurred.

Capacity / Commodity Split

We note that the review of LDZ charging arrangements in 2000 did not recommend any move away from the current averaging approach to setting charges but did recommend further consideration of the capacity / commodity split amongst other issues. The other issues were progressed but the capacity / commodity split was not, we therefore consider that it would be appropriate to review this at this time since some four years have elapsed since the recommendation was made, although we recognise that there is a linkage with the exit and interruption arrangements.

It is clear that a 50:50 split between capacity and commodity charges, as we currently have is not cost reflective in any way and that the way in which the true marginal costs has been marked-up to achieve this has lost any element of cost reflectivity. We accept that there are a number of ways of marking up costs that are valid approaches that do retain some degree of cost reflectivity and any of the options proposed would be an improvement on the current split. As is usual for changes to the pricing methodology that could have a significant cost impact on customers it might be prudent to phase in a change in the capacity / commodity split, first to 70:30 and ultimately 99:1 as this would appear to be the most cost reflective.

We are aware that Ofgem considers that the current exit and interruption arrangements may be causing undue discrimination between some firm and interruptible customers and between different types of interruptible customers, and that there are a number of options under consideration for reform. We note that a detailed case for reform has yet to be made and that the options are not limited to universal firm capacity and allocation by auctions, administered and tender approaches are also being considered. In any case we do not see that this should delay any further the introduction of a larger capacity / commodity split and hence more cost reflective charges.

Distribution Connection Charging Boundary

The Association supports a shallow connection policy and considers that it is appropriate that reinforcement costs are recovered through general transportation charges, since other sites current or future are likely to benefit from general reinforcement.

Any further changes to the connection policy should consider the impact on existing sites that have already paid connection charges or in the case of older sites also made a contribution to reinforcement costs.

Transco's Economic Test

The Association is concerned about the application of the economic test and any asymmetry that can arise from its application. We consider it would be appropriate for it to be reviewed and for there to be greater transparency in its application to ensure a non-discriminatory approach.

Implications for this Review of Sale of DN

This document states that Transco benefits from significant economies of scale. The potential sale of a DN must ensure that these economies of scale are not compromised. Any inefficient costs should be covered by the DN purchaser rather than reflected in increased charges to customers.

Ofgem considers that reform of the exit capacity regime is a gateway issue for the sale to proceed. If reform is shown to be necessary, there are likely to be implications for distribution charges, but it is not clear at this stage what those will be. However we consider cost reflectivity is a key principle that should be retained. Further consideration should be given to the issues above once the framework for the regime going forward is clearer and participants have sufficient time to consider the issues and implications of change more fully.

The potential divergence of distribution charging methodologies following the sale of one or more network is a concern. We consider that this could be detrimental to competition and costs to customers could rise as shippers would have to develop and maintain multiple billing systems in order to remain active in the retail market. However it is not clear how this is an issue for this review rather than an issue in respect of a DN sale.