

Potential sale of gas distribution networks

Governance of charging methodologies

Position paper

The purpose of this paper is to set out Ofgem's position on the processes by which changes to National Transmission System (NTS) and gas distribution network (DN) charging methodologies should be governed in the event that Transco sells one or more of its gas DN businesses. The paper also discusses issues that have been identified by shippers relating to changes to transportation charges.

In issuing this position paper, it is important to make clear that there can be no expectation on the part of Transco, potential DN purchasers or any other interested parties either as to what the Authority's final decision in relation to the proposed DN sales may be, or as to the regulatory framework which may be implemented if the Authority consents to the proposal. The information provided in this position paper is done so on an informal basis and should not be treated as binding on the Authority. Nothing in this position paper is to be construed as granting any rights or imposing any obligations on the Authority. The Authority's discretion in this matter will not be fettered by any statements made in this position paper.

Background

In its April 2004 Regulatory Impact Assessment on the governance and agency arrangements in the context of a potential DN sale, Ofgem outlined proposals for the creation of an independent governance entity. This entity would be responsible for the administration of network code modification proposals and changes to transmission and distribution charging methodologies and would effectively perform a secretariat function similar to that provided by ELEXON for the electricity balancing and settlement arrangements.

In performing its functions, the entity would be responsible for progressing modification and pricing methodology proposals through the governance process, chairing network code meetings, as well preparing modification reports and legal text. The entity would

also be responsible for managing the implementation of any methodology change including coordinating any changes with the Agency.

Under the proposed arrangements each network would retain responsibility for developing its own pricing consultations and would have the ability to raise its own network code modification proposals. In particular, enabling each network to raise its own proposals should assist in allowing networks to introduce innovative system operation services and thereby capture the benefits of introducing these services through the comparative regulation process.

Ofgem considered that the creation of an independent governance entity would assist in delivering the non-discriminatory treatment of network code and pricing methodology modification and consultation proposals.

Further, Ofgem considered that the creation of the independent governance entity would reduce the potential for fragmentation of the administration of pricing methodology arrangements across networks. In particular, the entity would be able to ensure equality of treatment of pricing consultation proposals and alert the industry to this during the development of such proposals before they are sent to the Authority for determination.

In its May 2004 conclusions on the Agency and Governance arrangements, Ofgem reported that most respondents indicated their support for the creation of an independent governance entity. Ofgem also stated that it supported the creation of such an entity on the basis that it would increase transparency and reduce the potential for undue discrimination as all proposals would be administered in a consistent manner regarding the origin of the proposal or the network to which it relates.

Issues arising from workgroup discussions

A number of issues have arisen from the workgroup discussions that relate to the charging methodology framework and the circumstances in which charges themselves can be changed. These are outlined as follows:

- ◆ To the extent that a methodology change raised by one DN is approved by Ofgem (or not vetoed as the case may be), then should all other DNs be required to make consistent changes to the methodology at the same time?

- ◆ Should the charging methodology objectives be changed such that DNs are required to maintain a degree of consistency with the charging methodologies of other DNs?
- ◆ Will Ofgem consider the costs that may be imposed upon shippers associated with a potential divergence in charging methodologies across network businesses?
- ◆ Should changes to the NTS charging methodology be managed through the process established by the independent governance entity?
- ◆ Should DNs be restricted to only making changes to charges once a year or on certain dates during the year?

Ofgem position

In this section we set out Ofgem's present position on the issues raised above. As noted above, the position presented in this paper in no way fetters the discretion of the Authority.

In considering its views on the issues raised above, Ofgem has reviewed the experience of the electricity sector. In making any decisions on the governance arrangements that should apply to charging and charging methodologies, Ofgem will where appropriate, take advantage of the lessons from electricity. However, it is important, when drawing on the electricity experience, to keep in mind that the starting position in gas and electricity varies considerably and therefore comparisons may not be appropriate.

Addressing the potential for divergence and fragmentation

Several industry participants have raised concerns that allowing individual DNs to develop their own charging methodology proposals may lead to fragmentation and divergent charging methodologies and that therefore all DNs should be required to make consistent changes to their charging methodologies at the same time.

Ofgem considers that that individual networks should be able to develop their own charging methodology proposals without requiring them to coordinate or make their changes consistent with other networks. If DN sales are permitted to proceed, then it is important to allow individual networks to capture the benefits of comparative regulation. In this respect, requiring networks to ensure that changes to charging methodologies are made consistent may reduce the incentive on network owners to

innovate. Further, Ofgem considers that it would be difficult to enforce such a licence condition against a DN to the extent that the DN was dependent on the behaviours of other DNs and their agreement to raise similar changes to their own methodologies.

Instead, Ofgem considers that it is preferable to consider the fragmentation impacts of introducing divergent charging methodologies in assessing whether to approve or veto a particular methodology proposal against the relevant charging methodology objectives. These objectives are currently set out in amended standard condition 4A of Transco's gas transporter's licence and it is likely, without fettering the discretion of the Authority, that a similar condition with similar objectives would appear in each DN licence.

As such, in assessing whether a particular methodology change proposal raised by an individual DN was acceptable, Ofgem would need to determine whether the methodology facilitates effective competition between gas shippers and gas suppliers. As part of its assessment Ofgem would therefore need to consider the potential impacts of divergences in charging methodologies on retail competition.

Further, and without fettering the discretion of the Authority, Ofgem does not consider it necessary to introduce any new methodology objectives that are specifically focussed on preventing fragmentation, as we are satisfied that these concerns can be addressed within the context of the present methodology objectives.

Changes to the NTS charging methodology

Ofgem considers that changes to NTS charging methodologies should be managed through the independent governance entity. Whilst Ofgem recognises that the NTS may adopt different methodologies to those adopted by the DN, it is nevertheless important that all change proposals are administered in a consistent manner. In particular, Ofgem considers that applying a consistent framework to the assessment of all change proposals, including those raised by Transco NTS, should minimise the potential for undue discrimination. It is particularly important in this respect that changes to Transco's methodology are addressed through the processes created by the governance entity so as to ensure a transparent process and to minimise the potential for Transco to discriminate in favour of its retained distribution networks.

Timing of changes to charges

During the workgroup process a number of shippers and customers have raised concerns that any potential sale of DNs will result in different DNs changing their charges at different times of the year depending on their revenue position.

In particular, concerns have been raised that frequent changes in charges across different DN businesses will increase complexity and may undermine competition in the retail sector.

Ofgem recognises this concern but would also note that DNs would have obligations to use best endeavours in setting their charges to ensure that revenues do not exceed their maximum allowed revenues in their respective price controls. These obligations are currently set out in special condition 28B Part 1a sub-paragraph (6) of Transco's GT licence and, without fettering the discretion of the Authority, are likely to be extended to DNs. Further, under special condition 28B Part 1a sub-paragraph (8), DNs also have financial incentives arrangements as set out in the Transco GT licence not to over recover revenue.

In view of this, Ofgem does not consider that it is appropriate to constrain individual network businesses to changing their charges once a year or on certain pre-specified dates. However, Ofgem recognises the concerns that have been raised and believes that consideration could be given to introducing requirements on Transco NTS and the DNs to use reasonable endeavours to only change their charges once a year on a specified date such as 1 October.

Further, Ofgem considers that the NTS and DNs should be required to publish to both shippers and customers ex ante revenue forecasts on a regular basis. Ofgem considers that this should enable shippers to forecast the potential for possible changes in transportation charges and therefore price their shipping and supply contracts more efficiently. Ofgem considers that more transparency in this area should promote competition.

Way forward

Ofgem intends to discuss this paper at the forthcoming meeting of the Development and Implementation Steering Group on 3 August 2004. Subject to the comments received in this paper, Ofgem would intend to address the issues set out in this paper further in its informal licence consultation document that is to be issued in early September 2004.

As part of this process, Ofgem envisages that considerable modifications are likely to be required to amended standard condition 4A to reflect the introduction of the independent governance entity.

Enquiries on this paper

Any enquiries regarding this paper should be directed to Mark Feather on 0207 901 7437.