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4 May 2005

GAS DISTRIBUTION CHARGES FROM OCTOBER 2005

1. Transco has today published indicative charges for its gas distribution networks (DNs). Changes to the existing charges are due to come into effect on 1 October 2005.¹ This letter sets out the background to these changes and seeks views on the issues these changes may raise.
2. Any responses to this letter should be received by 3 June 2005 and should be sent either by electronic mail to samanta.padalino@ofgem.gov.uk or by post to Samanta Padalino, Head of Gas Distribution Policy, 9 Millbank, London, SW1P 3GE.

Background

3. On 1 April 2004, special licence condition 28 B (part 1b) of Transco's Gas Transporter (GT) licence was modified to introduce eight separate price controls for each of Transco's DNs. Consequential licence modifications were also made to licence conditions 1, 4 and 4A to allow for separate DN transportation charges corresponding to the separate DN price controls².
4. In May 2004, in accordance with the process set out in its GT licence, Transco carried out a pricing consultation, PC 80 *Introduction of Different Levels of LDZ Charges between Networks*. It published its final report on 4 August 2004. PC 80 introduced a framework for changing charges across distribution networks that was consistent with the separation of Transco's LDZ price control. Specifically, under PC 80, the distribution charging methodology allowed for different levels of LDZ charges between different DNs with effect from 1 October 2005.
5. Transco initially proposed implementing PC 80 on 1 April 2005. However, respondents to Transco's consultation and participants at a meeting on 21 June 2004 requested that Transco postpone implementation of the revised methodology until 1 October 2005. The main

¹ Transco's notice of indicative distribution transportation charges can be viewed on the Joint Office's website at www.gasgovernance.com and on Transco's website at www.transco.uk.com.

² Ofgem's final proposals for the separation of Transco's distribution price control are outlined in its June 2003 document *Separation of Transco's distribution price control. Final Proposals*.

reason for this request was to allow shippers, suppliers and multi-site end users more time to make the changes to their IS systems which were necessary to accommodate regional variations in DN charges.

6. In accepting a later implementation date, Transco indicated that if price changes were to become necessary for the formula year 2005/06, then the inability to introduce them until October could result in percentage changes that are higher than they would have been had they been implemented in April. Ofgem did not veto Transco's final proposals for the reasons set out in our letter of 9 September 2004.
7. Under the provisions of their GT licences, DNs must use reasonable endeavours to give the Authority notice of a proposal to change their charges at least 150 days before the proposed date of implementation. This notice should include a reasonable estimate of the effects on charges and be published in such a manner that will secure adequate publicity for it. Furthermore, DNs have a reasonable endeavours obligation not to make changes to charges more frequently than once a year and for such change to take place on 1 October.
8. Under the network code arrangements, DNs are required to provide no less than two months notice to shippers prior to implementation of any revised transportation charges. This would require DNs to notify final changes to charges by 1 August 2005.

Changes to gas distribution charges

9. Table 1 sets out indicative changes to charges for each DN from October 2005 and forecast changes for October 2006. This table is explained in the report published by Transco today.

Table 1. Potential Volatility in Distribution Charges over the next two years

DN	October 2005 % change	October 2006 % change
East	9.4	- 4 to - 1
London	11.5	- 2 to 1
North West	- 4.8	8 to 11
West Midlands	1.9	4 to 7
North	8.5	- 4 to - 1
Scotland	1.1	- 4 to - 1
South	4.0	- 1 to 2
Wales and West	2.2	3 to 6
National weighted average	4.6	-

10. Transco has outlined three reasons for these changes:

- base change, which includes the application of the price control formula in accordance with the DN licences;
 - higher formula rates set by the Valuation Office Agency (VOA) for each DN, which will be phased in over three years and passed through according to the price control formula; and
 - the mains replacement programme (REPEX) incentive, which corrects on an annual basis for both efficiency savings and actual level of work undertaken.
11. A feature of the expected price change is the swing between October 2005 and 2006. In particular, large changes for some DNs in October 2005 could be followed by changes in the opposite direction in 2006.
12. The main reason for this swing is that, in October 2005, the DNs will need to adjust their revenue in order to re-balance two years worth of under or over-recoveries. By doing so, a DN with a cumulative under-recovery will need to set charges in October 2005 above their level in steady-state. While this would ensure that past revenue positions are re-balanced, it will also set charges higher than is sustainable under the price control formula. As a consequence, in October 2006, charges could require a downward adjustment. The opposite is true in the case of cumulative over-recovery.

Ofgem's views

13. Splitting a single price control into eight controls is, all other things being equal, likely to result in greater variability in changes to charges going forward. In addition, this variability has in some cases been exacerbated by:
- the delay in adjusting charges to rebalance over/under-recoveries after the separation of Transco's price control; and
 - the VOA re-evaluation of formula rates.
14. Although the REPEX incentive exhibits a larger degree of variability between DNs, it does not represent the main driver for the change, which is effectively the result of summing all three determinants.
15. Regional variation in charges was anticipated as a direct result of the separation of Transco's LDZ price control. However, the variability of charges between DNs and between years may appear to be larger than expected from the analysis undertaken as part of the price control separation and PC 80. Variability has always been present in electricity distribution charges where regional charges have been a feature of the market since privatisation.
16. This is the first year in which charges will diverge across DNs. Shippers and suppliers have been given time to adjust their billing and IS systems to accommodate regional variations in charges, since the publication of Ofgem's final proposals on the separation of Transco's LDZ price control in 2003. Nonetheless, Ofgem considers that, where possible, it is important to minimise unnecessary disruptions to DN users, so for example, in drafting the next price control licence condition it may be appropriate to consider whether incentive schemes that are calculated annually could be settled over the subsequent five year period.

17. For the remainder of this control period, Ofgem may also want to consider whether there are other options for implementing the expected changes in charges such that the potential concerns described above are ameliorated. Shippers, suppliers or other interested parties are invited to comment on the forthcoming price changes and to the extent that they consider these represent significant concerns to consider options for addressing them.

Next steps

18. We will consider any responses received in due course. In the meantime, please feel free to contact myself or Samanta Padalino on 020 7901 7033 if it would be helpful to discuss these matters further.

Joanna Whittington

Director – Gas distribution