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3 June 2003

Dear Ms Padalino,

Gas Distribution Charges from 1 October 2005

In an Ofgem letter of 4th May Joanna Whittington asked for views on the issues raised by the indicative charges for 1st October 2005 published by Transco on 4th May.

1. Volatility of price changes

The Ofgem letter points out in Table 1 that in several Networks a price increase in October 2005 will need to be followed by a price reduction the following October. In one Network a price reduction in October 2005 will be followed by a price increase the following year. The letter explains that the main reason for these swings is that in October 2005 the DNs will need to re-balance two years of over- or under-recovery, and the charges required to do so will be higher or lower than a steady-state level and therefore a compensating adjustment will be required in the following October.

Although the circumstances of 2005/06 are unusual because of the sale of four of the DNs, the “see-saw” effect described above has occurred in the past and may well occur again in the future. The new Licence condition, which limits changes to charges to only one date in the year, in fact makes this effect more likely, assuming that the revenue trends that lead to a change being necessary continue. This is because the sooner a price change can be implemented after it has become obvious that one is needed, subject to the notice requirements, the smaller the change will need to be. The longer the change is delayed, the larger it will need to be to clear accumulated under-or over-recovery, making it more likely that a change in the opposite direction will be needed the following October.

We know that these and similar issues were discussed at great length during the DISG process, in relation to licence condition D11. Whilst we understand the reasons for the position reached by the Authority, the practical problems indicated by the potential swings discussed above might mean that it is appropriate to look again at the specific terms of the condition. There are at least two ways that the propensity for a swing could be reduced:

- to modify the new Licence reasonable endeavours requirement so that charges could be changed on two dates in the year, 1 April and 1 October;
- to retain the reasonable endeavours requirement to change charges just once per year, but the transporter would have the flexibility to choose whether that change was on 1 April or 1 October.

Whilst we understand that shippers may not like the more flexible arrangements outlined above, we think that there is a tradeoff to be considered here, in terms of more or less flexibility set against more or less likelihood of greater volatility of year on year changes.

150 days Indicative Notice

Wales & West Utilities questions whether the 150 days indicative notice period really serves any useful purpose. The period is too extended for transporters to be able to give an accurate indication of the size of an expected price change. This is particularly so in the case of price changes on 1 October, for which indicative notice has to be given by 4th May. Transco traditionally produces its volume forecasts in the middle of May each year, and we understand will continue to do so. This means not only that the indicative notice changes have to be calculated on the basis of the previous year's forecasts, which will probably by then be well out-of-date, but also that a more up to date forecast is produced not long after the indicative notice is issued.

Experience has also shown that the DNMRA is not easy to forecast, mainly because of the difficulty of predicting the lengths of mains that will be decommissioned within a formula year. This difficulty is likely to be greater on an individual DN basis because of the lack of the offsetting movements that occurred on a national basis.

Wales & West Utilities suggests that the indicative notice period should be shortened to three months, as is now the case in electricity, as this would allow the forecasts to be based on more up-to-date information and therefore notice would be more accurate and more useful. In practice, shippers and suppliers do not, as far as we know, make serious and extensive pricing offers more than three months before the gas year begins, so our proposal ought not to create any problems in that regard.

Incentive Mechanisms

Within the determination of allowed revenue in the distribution price control the mains replacement incentive mechanism adjustment has proved a difficult element to forecast and it can contribute to the volatility of charges. Any mechanism that smoothed the adjustment over a number of years to make it both more stable and more predictable would be welcome.

Change in structure of charges

One of the factors which may have contributed to the wide spread of price changes notified for 1 October is the differential impact of weather across the networks, and the fact that movements in weather away from the seasonal normal temperatures

assumed in the forecasts will contribute to over- or under-recovery. This is because under the pricing structure inherited from Transco the weather sensitivity of billed revenue is much greater than that of allowed revenue. Allowed revenue is 35% sensitive to movements in composite volumes, whereas billed revenue is in Wales and the West is approximately 62% sensitive to movements in volumes. This means that difference in volumes transported compared to what was forecast, usually due to the effect of weather, will inevitably cause over- or under-recovery.

The way to mitigate this is to bring the weather sensitivity of billed revenue into line with that of allowed revenue. This could be done fairly easily with a relatively simple change to the charging methodology.

The customer charge for supply points with AQs of up to 73,200kWh is a simple commodity charge. The revenue from this charge represents approximately 27% of total billed revenue. If this charge were changed to a capacity based charge this 27% of revenue would cease to be weather sensitive and the weather sensitivity of billed revenue would fall to approximately 35%, in line with that of allowed revenue.

This would mean that the inevitable variations in weather away from seasonal normal temperatures would be far less likely to create over- or under-recovery because billed revenue and allowed revenue would move by approximately the same amounts. This would largely remove one source of over- or under-recovery and therefore contribute to increased price stability.

The change in the charging methodology would be justified because it would improve the cost reflectivity of the methodology, in that the costs reflected in the customer charge are supply point costs, and therefore are relatively fixed and do not vary with volumes. A capacity based charge would therefore be more appropriate than a commodity based one.

The change would be relatively easy to make and would have minimal distributional effects because it would only affect one class of customer and would not change the total amount of revenue collected from those customers under this charge. There is unlikely to be any impact on these customers (mainly domestic) because suppliers would be unlikely to change the way they charge to reflect this change. Shippers would probably welcome the greater stability and predictability of their charges.

If you would like to discuss any aspect of this letter please contact Steve Edwards on 02920 588092.

Yours sincerely,

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Wales & West Utilities

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