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value for all customers*

14 July 2005

GAS DISTRIBUTION CHARGES FROM OCTOBER 2005

1. On 4 May 2005, Transco published indicative charges for its gas distribution networks (DNs) from October 2005¹. On the same day Ofgem published a consultation letter² seeking views on the issues that the expected changes to charges raised.
2. Ofgem has given full consideration to the issues involved and respondents' views and has decided to allow DNs to change their charges to reflect fully the changes in allowed revenue pursuant to their existing price control formulas. This letter sets out the reasons behind this decision.

Background

3. Separate price controls for each DN have been in place since 1 April 2004. Charges will start varying on a DN basis for the first time from 1 October 2005. Transco's notice of indicative changes to charges from October 2005 stated that there could be a swing in charges between October 2005 and October 2006. More specifically, a large change in charges for some DNs in 2005 could be followed by a change in the opposite direction the following year.
4. There are three reasons for the variability in distribution charges from October 2005:
 - DNs will need to adjust their revenue in order to re-balance two years worth of over or under-recovery;
 - the Valuation Office Agency (VOA) has recently increased the formula rates for DNs. Formula rates are a simple pass-through element of the price control formula and VOA's rate changes are being phased in over three years; and

¹ Transco's notice of indicative 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 consultation letter can be viewed on the Ofgem website at www.ofgem.gov.uk under the Gas Distribution charges work strand.

- the revenue accrued by DNs under the mains replacement (REPEX) incentive mechanism, which corrects on an annual basis for both efficiency savings and level of work undertaken.
5. These components of the expected changes to charges were discussed in Ofgem's consultation letter of 4 May 2005.

Responses to Ofgem's consultation letter

6. Ofgem has received 10 responses, which have been placed on Ofgem's website. These are the main comments received:
- the majority of respondents supported the principle of stable and predictable charges which was considered at odds with the forecast price changes for 2005 and 2006;
 - the majority of respondents believed that swings in charges between years were unsettling for both shippers and customers in terms of efficiency and customer confidence;
 - one respondent stated that in the future variability of distribution charges would be less pronounced, as the 2005/06 changes are temporary and largely driven by the VOA's rates increase and by the delay in implementing diverging DN charges;
 - some respondents suggested a smoothing of changes to charges over the remainder of the price control to reduce the swing in charges between years;
 - some respondents also offered solutions for dealing with possible future variability of charges, including a smoothing mechanism to be adopted on a rolling basis that could span price controls and the lengthening of the settlement period for the REPEX mechanism; and
 - one respondent opposed any move to lengthen the settlement period of the incentive scheme in the belief that the advantages of the efficiency drivers provided by an annual scheme outweigh the costs of variability of charges.

Ofgem's views

7. Ofgem has considered a number of possible alternatives to allowing the changes to charges outlined by Transco last May. However, none of the alternatives would be easy to implement and provide significant benefits in terms of reduced variability of charges. Each of them would require modifications to the DN's gas transporters (GT) licences.
8. In particular, by smoothing the change in charges and, in some cases, by not allowing charges to change fully:

- some DNs would over-recover in March 2006 and, as a consequence, would be subject to a punitive interest rate on any revenue over-recovery, unless a licence modification is consulted and agreed upon; and
 - some DNs would be forced to under-recover and, as a consequence, may face short-term cash flow constraints.
9. Further, Ofgem considers that the variability in charges is largely driven by events that should have only a temporary impact on charges over the next two years. Charges from October 2007 are expected to exhibit less variability as a result of:
- the change due to the re-balancing of price control revenue becoming smaller, as charges get closer to their steady state level and are assessed annually; and
 - smaller VOA rates increases, which will disappear after October 2007.
10. Variability has also been a feature of electricity distribution charges where regional charges have been in place since privatisation. If the variability of gas distribution charges were to persist or increase unduly, Ofgem might consider the issues associated with it as part of the forthcoming review of the gas distribution price control.
11. Finally, Ofgem considers that shippers and suppliers have been provided with sufficient time to prepare their commercial strategies and change their IT systems to accommodate changes to distribution charges. As outlined in Ofgem's May consultation letter, final proposals to separate the distribution price control were published in June 2003, while on 9 September 2004 Ofgem published a decision letter, which did not veto Pricing Consultation 80 (PC 80) *Introduction of Different Levels of LDZ Charges between Networks*. PC 80 allowed DNs to change charges to reflect fully their separated price controls starting from 1 October 2005.

Next steps

12. In accordance with the Uniform Network Code, DNs are required to notify final changes to charges by 1 August 2005 for implementation on 1 October 2005.
13. If you would like to discuss this matter further, please contact me on 020 7901 7046 or Samanta Padalino, Head of Gas Distribution Policy, on 020 7901 7033.

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