Structure of gas distribution charges – Initial Proposals – July 2005

WWU RESPONSE - EXECUTIVE SUMMARY

Cost reflectivity of use-of-system charges

We do not support the introduction of distance related charging in gas distribution.

Capacity / commodity split

Any wholesale changes to the capacity/commodity split should be introduced in conjunction with the reform of the existing interruption regime.

The equity impact of a change in the capacity and commodity split needs to be considered. An increase in the capacity element may increase charges for domestic customers.

Under the relative price control caps, IGTs could receive a windfall gain through a change to WWU's pricing structure that has a neutral impact on WWU.

The Economic Test (ET)

WWU support retaining the ET model.

The model needs to be changed to take account of regionalisation, NTS exit and DN interruption reform.

WWU does not support publishing the model as this will provide opportunities for gaming whereby customers may seek to reduce connection charges at the expense of customers generally.

CSEP Administration Charge

WWU support the Ofgem proposals.

Customer charge

WWU agrees that the customer charge should be capacity based. The proposal to require the DNs to create a function that is only capacity based would take a considerable amount of time to implement.

WWU propose a change to the 0-72.3MWh load band (mainly domestic) that would achieve most of the benefits sought whilst being simple and could be implemented by 1 April 2006.

Surveys and Audits

WWU agree that these data sources need to be either updated and/or reviewed.

Next Steps

It would be essential to check whether Xoserve's billing systems will be able to accommodate changes to the charging methodology as early as April 2006

1. Cost reflectivity of use-of-system charges

Wales & West Utilities (WWU) agree with Ofgem's conclusion that it is not worth changing the charging model at present.

We do not support the introduction of distance related charging in gas distribution as:-

i Customers at the end of long networks may see increased charges. However such charges are wholly ineffective as there is nothing customers can do, bar moving house, to respond to these price signals;

ii We would need to precisely calculate the distance from the offtake to every individual's connection. These is a massive task requiring a significant amount of resources and will result in very significant costs;

iii gas distribution networks are generally more complex than transmission and gas can flow by different routes between offtakes and supply points. Therefore the distance the gas travels to reach a supply point may vary depending on network conditions.

It is therefore difficult to see how a distance related charging structure which would be transparent, fair between users, and practical from an implementation point of view could be developed.

2. Capacity / commodity split

WWU agree with Ofgem's proposal that any wholesale change to the capacity/commodity split should be introduced in conjunction with the reform of the existing interruption regime. Apart from helping to promote equitable treatment between firm and interruptible customers it will allow time for proposals to be developed and considered in depth. This is particularly important in the case of the new DNs which will need time to examine the cost structures of their networks to see if they agree with the figures produced by Transco. WWU therefore suggests that it is premature to present only two options - a 70:30 split or a 99:1 split. The options should only be finalised after the DNs have had time to examine their cost structures post the 1st June completion and make their own proposals, as they may not agree with Transco's figures. This could be done consistent with the 1 October 2007 timescale for the revised DN interruption arrangements.

With respect to whether Transco's estimate that marginal cost charging would allow DNs to recover only 40% of their costs is robust, the DNs require access to the detail behind the Transco calculations and then time to gather the information and perform the calculations with respect to their own networks. That said, we also note that typically in network analysis marginal cost pricing approaches do not lead to full cost recovery, and there are inevitable debates about the appropriate form of the necessary uplift to achieve that, and what in turn the uplift does to price signals. In general, therefore, whilst we accept that marginal costs need to be understood, we do not favour them being the basis of our charges.

The equity impact of a change in the capacity and commodity split needs to be considered. An increase in the capacity element may increase charges for domestic customers. The impact of this change on low usage customers needs to be assessed. Suppliers and Transporters may face adverse comment if these customers see increases in energy costs.

The impact on IGTs also needs considering. Most IGTs transport to predominately domestic premises. If the impact of a change to the capacity commodity split is a rise of 10% on the final domestic customer charge and the impact on the CSEP charge is also a rise of 10% then IGTs will receive a windfall gain through a change to WWU's pricing structure that has a neutral impact on WWU.

.

3. The Economic Test (ET)

WWU support Ofgem's conclusion that the ET should be retained. WWU also agrees with Ofgem that the parameters used in the model should not be allowed to become out-of-date. The model needs to be changed to take account of regionalisation, NTS exit and DN interruption reform. With respect to different appraisal periods for process and non-process loads, while these could make the ET more sensitive further analysis is needed to consider what those appraisal periods should be and whether a realistic distinction between process and non-process loads is in fact possible in most cases.

WWU does not support publishing the model as this will provide opportunities for gaming as customers seek to minimise connection charges. If they understand the model in detail, this will inevitably provide opportunities to amend connection proposals to ensure that more of the costs are picked up by the network and less by the applicant. In our case, this will result in WWU paying for the whole or part of the connection based on the assumption that we will recover the cost through higher transportation charges. If this does not occur the cost has to be born initially by ourselves and then by the generality of customers. Within the current price control, assuming the capex has not been allowed for, the impact of such gaming is to impose capex on WWU that is not paid for by transportation revenue; WWU therefore bears the working capital costs which it cannot recover. In the next price control period this capex is included in WWU's Regulated Asset Value and a return is received from transportation charges recover over the entire customer base. Gaming therefore benefits the connecting party at the expense of the generality of customers and funding requirements of the regulated business.

All licensed Transporters should be required to publish their Economic Test or Tariff Support Allowance models if such a decision is reached.

4. CSEP Administration Charge

WWU support the Ofgem proposals.

5. Customer charge

WWU agrees in principle with Ofgem's proposal that the customer charge should be capacity based. However the proposal to require the DNs to create a function that is only capacity based would take a considerable amount of time to implement. This is because it would involve all the DNs undertaking a detailed review of the costs underlying the customer charge and relating these costs to supply points within load bands.

Whilst a detailed analysis has not been undertaken the approach suggested below is consistent with the charging principles. Therefore WWU propose that an alternative solution which would achieve most of the benefits noted by Ofgem simply and quickly would be to change the customer charge for the 0-72.3 MWh load band (mainly domestic) from being commodity based to capacity based. As this is the only part of the charge which is currently commodity based the change would meet Ofgem's proposal that the charge should be capacity based. This change could be done to meet the 1 April 2006 timescale suggested by Ofgem in section 5 - Next Steps.

This change would achieve the benefit mentioned by Ofgem of providing the DNs with more predictable revenue, but it would contribute significantly to another benefit, namely a reduction in the frequency and size of price changes. The reason for this is illustrated by the tables below showing the proportion of revenue from capacity and commodity charges.

Table 1: Proportion of Revenue recovered by Current Charges
(The figures shown are typical network figures rather than specific to one Network)

	LDZ System Charges	Customer Charges	Total
	%	%	%
Capacity	35	2	37
Commodity	35	28	63
Total	70	30	100

This means that approximately 63% of billed revenue is sensitive to weather induced changes in volumes, and 37% of the revenue is relatively fixed. This is of course almost exactly the reverse of the proportions under the price control formula, where 35% of allowed revenue is weather sensitive and 65% is fixed.

The disparity in the weather sensitive proportions of billed and allowed revenue leads to under- or over- recovery which in turn leads on to the need to change charges more frequently and by larger amounts than would otherwise be necessary. It is one factor causing the range of changes in the charges being proposed by the Networks for 1 October. This instability of charges is disliked by the shippers and creates more work and uncertainty for the Networks.

The effect of the proposed change to make the 0-73.2MWh customer charge capacity based would be to bring the weather sensitivity of billed and allowed revenue virtually into line, so that as volumes vary with temperature the impact on billed revenue and allowed revenue would be virtually the same. This would reduce the amount of over- or under-recovery experienced by the Networks and reduce the frequency of price changes**.** The table below summarises the effect of the proposed change.

Table 2: Proportion of Revenue recovered after proposed change
(The figures shown are typical network figures rather than specific to one Network)

	LDZ System Charges	Customer Charges	Total
	%	%	%
Capacity	35	30	65
Commodity	35	0	35
Total	70	30	100

If this change were made it would remove the main disadvantages of the customer charge as it is currently structured and it could be done in line with Ofgem's proposed timescale of 1 April 2006 as all that would be required is a straightforward change to the charging methodology. Thereafter further analysis could be undertaken carry out a more fundamental review of the customer charge.

6. Surveys and Audits

WWU agree with Ofgem that these data sources need to be either updated and/or reviewed but also stresses that they need to be done on a DN basis in order for the results to be useful in a review of the DNs' own charging functions. It will take the DNs some time to do this. WWU also stress that all the information available to Transco from the previous surveys and cost analyses on a national basis should be made available to the DNs as this would help them in structuring and scoping their own surveys and analyses.

8. Next Steps

WW&U support Ofgem's proposal that any wholesale changes in the level of charges and/or the charging methodology associated with Ofgem's final proposals for the capacity/commodity split could be implemented on 1 October 2007.

However the proposal that Ofgem's final proposals for all areas of the structure of gas distribution charges except the capacity commodity split should be implemented on 1 April 2006 seems to propose an unrealistically short timescale and does not fit with the norm of only changing prices every October. There is simply not enough time between now and December 2005, when Ofgem propose to publish their final proposals, for any useful DN based analysis to be done, particularly on the ET and the customer charge. The one change which could be proposed and implemented on this timescale would be to make the customer charge for the 0-73.2MWh load band capacity based instead of commodity based.

It might be possible to implement some other changes on 1 October 2006, but 1 October 2007 would be a more realistic date. Adopting a time-scale based on 1 October 2007 would also allow a co-ordinated approach to be taken to the whole structure of charges. The DNs might, for example, want to consider whether the customer charge should be removed altogether and all the revenue (apart from that from the admin charges) collected by the system charges.

It would be essential to check whether Xoserve's billing systems will be able to accommodate changes to the charging methodology as early as April 2006. WWU understand that the amendment of the billing systems to cope with differential levels of charges within the same methodology has in itself been a major task.