Structure of Gas Distribution Charges – Initial Proposals

Transco Distribution Response

Introduction

Transco Distribution welcomes the opportunity to comment on Ofgem's consultation on its initial proposals for the structure of gas distribution charges.

In general we are supportive of many of Ofgem's proposals. The concerns that we have focus on two main areas. Firstly, with regards to the timing of possible changes, the potential interactions with DN interruption reform and the 2008 price control review process need to be considered further to ensure that any changes to the charging structure are co-ordinated with other potential changes. Secondly, the costs of reviews and of implementing changes, for both DNs and shippers, and the potential impacts upon consumers, need to be properly allowed for in determining the way forward.

These concerns, together with other issues, are set out in more detail in our response below to each of the issues raised by Ofgem.

Cost-Reflectivity of Use of System Charges

We consider that the current charging structure provides an appropriate balance between simplicity and cost-reflectivity and believe that any benefits of moving to a distance-related structure would be outweighed by the disadvantages of cost and complexity at present.

We would note, however, that it may be desirable to modify the structure of DN charges in other ways at the time when the enduring changes for NTS exit reform are put in place, as current proposals would make the DNs responsible for purchasing NTS exit capacity products and this would introduce substantial changes to the DN cost structure.

Capacity / Commodity Split

In light of the interaction with DN interruption reform, we agree that any change to the capacity / commodity split should be implemented at a time consistent with the introduction of revised interruption arrangements and consequently that any change should not be made prior to October 2007.

We consider that an increase in the capacity weighting of the DN system charges is appropriate but that this change should be made in conjunction with reform of the interruption regime. However, we believe it is premature at this time to determine whether a 70:30, 99:1 or other split is the most appropriate final split of capacity and commodity charges. Further analysis is required to confirm that the current high levels of investment in the Distribution Networks have not altered the view of the appropriate capacity / commodity split, which is based on analysis undertaken some time ago.

An interaction that needs to be considered is the introduction this year of a DN incentive around the requirement for NTS exit capacity products. This has increased the level of risk for DNs and created greater uncertainty in the level of DN allowable revenue. Since this incentive relates explicitly to capacity products but has an

uncertain revenue impact, it may be best, under any revised methodology, for this element to be outside of any set capacity / commodity split calculation and for the forecast incentive outcome to be then included in the capacity revenue target for the DN system charges. This would mean that the overall DN capacity / commodity target revenue split would be slightly variable from year to year depending upon the forecast incentive outcome.

A further consideration is the impact of any change on the stability and predictability of DN transportation charges since more predictable and stable charges can better facilitate effective competition between shippers. Ofgem states that increasing the proportion of revenue recovered through capacity charges should give more stable income flows, resulting in more predictable transportation charges. However, this is not necessarily the case, since the predictability of charge levels depends upon the interaction between the allowable revenue, as determined through the price control, and the collectable revenue.

Under the present DN price controls, the main element of the DN allowable revenue is 35% variable with throughput. If the DN charges were, say, based totally on capacity charges then variations in throughput levels would impact on DN allowable revenue but not on collected revenue leading to potentially large K outcomes and unstable charge levels from year to year. From a charge stability viewpoint, the overall DN capacity / commodity split should be such that the revenue sensitivity to throughput variations which cannot be predicted accurately (e.g. those related to weather conditions) is the same for collectable revenue as for allowable revenue.

Although cost-reflectivity is the main objective, the present cost analysis indicates that, beyond the level reflecting the marginal cost sensitivity, there is considerable choice available as to the most appropriate capacity / commodity split. It is therefore appropriate to take other factors such as the impact on charge stability into account. However, the opportunity to align the allowable and collectable commodity revenue sensitivities needs to take into account the structure of the next DN price control, expected to be in place from April 2008, which may differ from the existing price control structure.

A proposal to change the pricing methodology impacting the capacity / commodity split will be required by May 2007 at the latest for implementation in October 2007. At that time the definitive structures of the DN price control proposals for 2008 may not be known. It may be worth considering an interim change to the split for October 2007 prior to a further change for October 2008, when the structure of the next DN price control is known. An interim, or phased, implementation of the change may also be beneficial in spreading the distributional impacts on shippers and consumers of a change over more than one period. However, for the purposes of DN interruption reform it is important that any phased implementation of a change to the capacity / commodity split does not impact adversely on any potential new interruption arrangements so as to reduce their efficiency, particularly if long-term interruption arrangements are to be made from October 2007.

If the capacity / commodity split is changed then the charges in respect of smaller supply points should not change other than due to the differing load factors of different types of consumers. For domestic supply points, the capacity charge in respect of a small supply point should be low, since it will have a low AQ, whereas for a large domestic supply point, with a large AQ, there would be a higher capacity charge. The charges in respect of domestic supply points would thus continue to reflect their size. There is therefore little reason why this change should lead to suppliers introducing a standing charge in their domestic billing structures.

The Economic Test

Transco considers that the Economic Test is a key element in meeting the requirements of the Gas Act, in respect of only connecting loads where it is economic to do so. We are therefore pleased that Ofgem considers that the test should be retained.

We agree that the economic risk associated with a new load depends upon the type of the load and that the distinction between process and non-process loads is a key discriminator of that risk. However, it is difficult to determine a robust definition for distinguishing between these two types of loads.

Possible alternative criteria, which could act as a proxy for distinguishing between process and non-process loads, are load size or whether the load is daily metered (DM) or not (NDM). Of these alternatives we consider that the use of the DM / NDM identifier is the best proxy of the distinction between process and non-process loads and has the advantage of being a criterion which is less susceptible to manipulation than load size.

We agree that for process loads, as identified by the suggested criterion, there should be a shorter appraisal period, say 20 years, to reflect the risks of closure and the likely shorter economic lifetime of the process assets whereas for non-process loads the appraisal period should be based upon the typical life of the connection and reinforcement assets.

With regard to updating the parameters of the test, we agree that the discount rate used should be revised to be consistent with the prevailing allowed cost of capital for the current price control period, 6.25% at present and that, except for process loads, the depreciation period should reflect the most recent estimate of the average economic life of connection and reinforcement assets. For process loads a depreciation period consistent with the shorter appraisal period should be used.

In respect of the concerns about the lack of transparency of the Economic Test, Transco has made available the description in Appendix 2 of Ofgem's consultation document, which we consider provides a good description of the methods and principles of the test.

We remain concerned that the release of information on the precise parameters used within the test could, at present, lead to gaming by new connectees in declaring their expected gas demand. This is due to the fact that connectees can declare a high expected throughput level, which will increase the forecast collected transportation revenue within the test.

However, if the proposal to implement a change in the capacity / commodity split is carried through, particularly to a very high capacity proportion, then this concern would reduce, since the impact of a gamed throughput figure would be far less than at present. We therefore think that this issue could significantly reduce or even disappear within a couple of years.

If the potential changes to the capacity / commodity split are not implemented then another way of minimising the gaming issue would be to require new connectees to sign a new connection agreement guaranteeing that a minimum level of transportation charges would be payable, based upon the parameters provided to ascertain the Economic Test, for a number of years e.g. an ARCA. However, the

approach of increasing the capacity element of the DN transportation charges would seem the easiest way of both reducing this gaming issue and improving the cost-reflectivity of charges.

CSEP Administration Charge

We consider that the current charge accurately reflects the costs incurred in managing CSEP information under the present process. The charge has reduced considerably since it was first introduced due to the economies of scale of dealing with the growing number of CSEPs under the present process. There is no reason to believe that the current process is close to reaching its capacity limit and thus we would not at present expect an increase in the charge at the next review. We support reviewing the costs under the present process every two years and believe a cost-benefit assessment of the possibility of switching to an automated process should be done only if it is likely to show clear benefits.

Customer Charge

We support changing the basis of the customer charge in respect of domestic supply points (strictly, those with an AQ up to 73.2 MWh) from a commodity basis to a capacity basis. The customer charge reflects the costs of providing and maintaining service pipes and of providing the emergency service. Although these costs do not have a simple relationship to the supply point capacity, they relate more to capacity than to throughput and so, in respect of cost reflectivity, it would be beneficial for the customer charge to be levied on a capacity basis.

There will be implementation costs for switching to a capacity-based domestic customer charge, both in terms of review costs and xoserve and shipper implementation costs. However, if the charge were based on a simple unit capacity charge, with or without a fixed element, we would not expect these to be excessive.

The switch to a domestic customer charge based upon a fixed element and a simple unit capacity element (as for smaller I&C supply points) would also potentially allow the present customer charge discontinuities at the AQ of 73.2 MWh to be addressed.

The impact of such a change on the stability of charges across years is similar to that for changing the capacity / commodity split, being dependent upon the interaction with the price control allowable revenue. In the absence of a change to the capacity / commodity split of the DN system charges, the change to a capacity basis for the domestic customer charge would bring the commodity revenue exposure of the DN collectable revenue more closely into line with that of the allowable revenue, under the present price control, and so should give greater predictability and stability of charges from year to year, so helping facilitate effective shipper competition.

The impact of any change on domestic consumers, in terms of environmental impacts and vulnerable customers, depends upon whether this change would result in suppliers changing the structure of their charges to domestic consumers. At present, suppliers' charging structures for domestic consumers do not reflect the structure of the transportation charges to shippers. However, the possible influence of a change to the customer transportation charge on suppliers' charges, and particularly the potential impact on vulnerable consumers, needs to be taken into account, along with cost-reflectivity and the other relevant methodology objectives, when determining the structure of a revised domestic customer charge.

Surveys and Auditing

Transco agrees that data which underlies the charging functions should be reviewed from time to time. The frequency of undertaking such reviews should take into consideration the costs of such reviews, the likelihood of the review resulting in information which is substantially different from that used at present, and the likely level of benefit of implementing a change to the structure or relative level of charges based upon the revised information

For example, although the information gained from the survey of connections by pressure tier was obtained some years ago, we would not expect a new national survey to give results which are very different since the population of gas supply points is growing at a relatively low level and once supply points are connected they do not change significantly, unless the load disappears or varies substantially.

However, the cost-reflectivity of DN charges should now be in terms of the costs incurred within the DN business rather than nationally, and so it is appropriate to review the information on a DN basis. The benefits of introducing revised charges based on DN-specific information, and possibly of introducing, say, different transportation charging functions in different DNs to best reflect the different pattern of costs in different DNs, even with the same underlying methodology, will need to be considered against the review costs and the potentially large xoserve and shipper billing implementation costs, if charging structures vary by DN.

Transco agrees that it would be beneficial to review the cost of growth figures used within the Economic Test to ensure they reflect the DN costs. We believe it would be best to co-ordinate this with any analysis that is required for the DN price control review, to avoid inefficiencies in review costs, and so the timing of the review should be driven by the PCR timetable.

With regard to a potential audit of the Activity Based Costing (ABC) analysis used to allocate costs to different business activities, and which underlie the charging functions, we are concerned that the costs of such an audit may be disproportionate to the potential benefits arising and so believe that the scope and timing of any audit should be carefully considered to avoid this outcome. Analysis of the cost structures of the DN activities will doubtless be provided to Ofgem as part of the Price Control Review leading to the 2008 price controls and will be subject to extensive scrutiny at that time. We believe that rather than have a separate audit in the near future, the verification of the model used to allocate costs should be done as part of the PCR process, so avoiding duplication of effort and cost.

We hope that these comments are helpful in determining the way forward for the structure of gas distribution charges. If you have any queries or would like to discuss this response please contact Steve Armstrong (Tel 01926 655834).