



Gas Transporters, shippers and
interested parties

*Promoting choice and
value for all customers*

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Dear Colleague,

Proposal to modify Standard Special licence conditions A4, A5 and D11 of the Gas Transporter licence

Introduction

1. Against a background of significant variability in the level of gas distribution charges since the introduction of individual Distribution Network (DN) charging regimes, Ofgem is proposing to modify Standard Special Conditions (SSC) A4¹, A5² and D11³ of the Gas Transporter (GT) licence in a manner that will increase stability in the level of charges. The licence modifications proposed will:
 - allow DNs to update distribution charges twice a year on 1 April and 1 October, or at any other time as directed by the Authority; and
 - reduce the notice period for indicative charges that DNs are required to give the Authority of a change in the level of distribution charges from 150 days to three months.
2. This letter sets out the rationale behind the proposed licence amendments and invites views on whether or not they are appropriate. Responses to this letter should be sent in electronic format to indra.thillainathan@ofgem.gov.uk to be received no later than **5.00pm on 31 August 2007**.

Background

3. Under SS4A of the GT licence which governs charging, DNs have the following reasonable endeavours obligations to:
 - only update distribution charges once a year on 1 October, or at any other time as directed by the Authority⁴; and
 - provide the Authority with indicative charges 150 days prior to updating the level of distribution charges.

¹ SS4A: *Charging-general*

² SS4A5: *Obligations as regards charging methodology*

³ SS4D11: *Charging obligations*

⁴ Obligation is also contained in SSCs A5 and D11

4. The first obligation, allowing only one update of distribution charges per annum, was introduced following the sale of four distribution networks by National Grid in May 2005. The introduction of this obligation recognised shippers' concerns that the change in ownership of these four DNs could lead to multiple charging updates throughout the year. It was considered that multiple updates would impose unacceptable additional costs on shippers, and as such could adversely impact on competition between shippers and suppliers.
5. The second obligation requires DNs to provide the Authority with indicative charges 150 days prior to updating the level of distribution charges. Given that DNs have a reasonable endeavours obligation to update distribution charges on 1 October, indicative charges must be provided to the Authority in early May. In addition the DNs obligation to give two months notice of definitive charges requires that they be published on 1 August to meet the 1 October obligation⁵.
6. Ofgem is reviewing both these obligations against a background of significant variability in the level of gas distribution charges. We consider that amending these licence obligations in conjunction with other measures being considered should have the effect of significantly reducing this variability. These other measures include our proposal as part of the Gas Distribution Price Control to remove the volume related revenue driver. We also note that UNC Mod 160 has been raised recently to provide shippers with more information about the elements of price control revenue to enable them to forecast better changes in transportation charges.

The proposals for licence modification

Allow DNs to update distribution charges twice a year

7. As things stand, gas distribution charges are updated on 1 October each year while allowed revenue under the price control is measured on a formula year, 1 April to 31 March basis. This mis-match between the charging and formula years has been a significant contributing factor to the variability in the level of charges for two reasons:
 - adjusting the level of charges on 1 October mid way through a formula year requires that the magnitude of any change aimed at meeting a target allowed revenue over the full year must be greater than if the adjustment had been made at the beginning of the period; and
 - variability tends to be reinforced over time as a large increase in one period leads to the need for a large decrease in the next and so on.
8. In October 2006 we consulted⁶ on the merits of aligning the charging and formula years, by amending the obligation to update charges only once a year from 1 October to 1 April each year.
9. Respondents were asked to consider whether the costs of moving the start of the gas charging year from 1 October to 1 April would be outweighed by the benefits. Of the eight who responded to this consultation document six supported the idea while two did not. The two negative responses considered that retaining the ability to update charges on 1 October was imperative to allow DNs to take into account the effect of variations in throughput on allowed and collected revenues during the first half of the formula year. This they added would not be possible with a 1 April date as the licence requirement to give two months notice of definitive charges would require them to set charges mid way through the winter period. As such, a significant portion of annual throughput and thus collected and allowed revenue would be excluded from the setting of charges. It was

⁵ The UNC also sets down a two month notice period for GDNs to inform users of a definitive change pursuant to SSC4A

⁶ *Reform of interruption arrangements on gas distribution networks – An update, October 2006*

considered that this could lead to greater variability. One respondent⁷ to the November price control consultation document thought that a convincing case for alignment of the charging year with the formula year should take account of other developments including, for example, any future changes to the capacity/commodity split.

10. The two negative responses suggested as an alternative, amending the licence obligation such that DNs could update their distribution charges on both 1 October and 1 April each year. This option was considered to have the benefits associated with retaining the 1 October date outlined above, while giving the additional flexibility associated with aligning the charging and formula years.

Reduce the indicative notice period from five to three months

11. It has become apparent over time that while indicative charges in general tend to signal the direction of movement in definitive charges, they are less useful in signalling the magnitude of change. This is illustrated by the table below. For example, while indicative charges for the North West in 2006 showed an increase of 15.7% definitive charges increased by 19.7%.
12. This variance is due to the requirement for a 150 day notification period meaning that indicative charges need to be published in early May with the definitive charges being published three months later on 1 August. Indicative charges are therefore based on three months fewer throughput data, including that for the important shoulder month of April that only becomes available in mid May. In addition they do not reflect the effect of the final REPEX incentive adjustment to allowed revenue that occurs in mid July.

Table 1. Indicative and Actual price changes in 2005 and 2006

GDN	2005		2006	
	Indicative Oct '05 price change (published in May)	Actual Oct '05 price change (published in Aug)	Indicative Oct '05 price change (published in May)	Actual Oct '05 price change (published in Aug)
East	9.4%	12%	10.6%	12.3%
North West	-4.8%	-5.9%	15.7%	19.7%
London	11.5	4.7%	-14.4%	-12.1%
West Midlands	1.9%	4.2%	11.8%	12.2%
Scotland	1.1%	4.5%	0%	5%
South	4.0%	2.7%	0%	6.3%
Wales & West	2.2%	3.5%	4.0%	4.0%
North	8.5%	8.5%	-6.0%	-1.0%

13. We consider that shortening the notice period to three months would make indicative charges a better reflection of the subsequent definitive charges. Our view is that wide variation between indicative and definitive charges greatly reduces the value of the former to industry.

Consistency with electricity distribution

14. The proposed changes would bring the arrangements in the gas distribution industry closer to those recently agreed for electricity distribution. In June 2007, Ofgem published a decision letter⁸ directing a proposed variation be made to the DCUSA

⁷ GDPCR Third consultation document- 27 November 2007

⁸ DCUSA: Proposed move to annual amendment of DUoS charges (DCP001), 22 June 2007

requiring distributors (DNOs and IDNOs) to use reasonable endeavours to amend tariffs no more than twice a year, with the change to take effect from 1 April and 1 October. Previously no restrictions had been placed on DNOs as to when or how often they could update tariffs in a given year. In making this decision we concluded that the proposal would better facilitate effective competition in the supply of electricity. Reducing the unpredictability of when updates would occur, suppliers' level of risk and therefore costs would be reduced as a result. We also concluded that the proposal would not impact on the DNOs' ability to develop an economic and efficient distribution system.

15. The electricity distribution licence requires licensees to give three months notice of tariff changes, including indicative charges. The DCUSA requires distributors to give 40 days notice of final charges.

Recommendation 1

16. We recommend amending the reasonable endeavours obligation contained in SSC A4, A5 and D11 so that DNs are able to update charges twice a year on 1 April and 1 October, or any other time as directed by the Authority. We consider that this would better facilitate DNs in discharging their licence obligations with respect to setting charges such that they do not over or under recover against allowed revenue. In turn, this would help minimise variability in the level of charges between formula years that has been particularly evident since DN sales.
17. We consider that any incremental costs associated with increasing the frequency of charges updates will be outweighed by the benefits of more stable charges, and as such should not prove detrimental to the promotion of effective competition between relevant shippers and suppliers.

Recommendation 2

18. Ofgem recommends reducing the notice period for indicative charges related to a change in the level of charges from 150 days to three months. This will reduce the variation currently being seen between indicative and definitive changes.

Next steps

19. If, after having considered responses received to this letter, we decide it is appropriate to modify the GT licence, we would expect to publish a statutory notice to modify SSCs A4, A5 and D11 in September 2007.
20. In the meantime, please feel free to contact Indra Thillainathan on 020 7901 7294 if you would like to discuss this letter further.

Yours sincerely,

Joanna Whittington
Director, Gas Distribution