Modification proposal:	Joint GDN charging modification proposal DNPC03 – LDZ system charges capacity commodity split and interruptible discounts.		
Decision:	The Authority[1] has decided not to veto this proposal[2]		
Target Audience:	Gas transporters, gas shippers, gas suppliers, gas customers and other interested parties.		
Date of publication	**13 December 2007**	Implementation date:	**1 October 2008**

Background to the modification proposal

Use of System charges recover costs that relate to the provision, maintenance and operation of the distribution network. Revenue is collected from separate capacity and commodity charging functions: the former being collected on the basis of peak day capacity as measured by Supply Offtake Quantity (SOQ) with the latter being collected on actual annual consumption. At present the separate charging functions are set such that total revenue is split 50:50 between the separate functions.

Ofgem conducted a review of the structure of gas distribution charges over the period May 2004 to February 2006[3]. During this period Ofgem conducted an initial Impact Assessment[4] on the issue of shifting the balance of Use of System charges towards a more capacity based charging regime. Ofgem concluded that in principal such a rebalancing would allow the GDNs to fulfil better the objectives of their charging methodology, as set out in their GT Licence. Ofgem also concluded that rebalancing should only occur following reform of interruption arrangements on distribution networks. Without such reform, rebalancing could lead to inappropriate reductions in transportation charges for interruptible supply points. In addition Ofgem committed to updating the IA prior to making a determination on any future proposal by GDNs to alter the existing balance of Use of System charges.

On 1 April 2007 the Authority directed implementation of UNC 090[5] introducing reformed interruption arrangements on distribution networks, commencing on 1 October 2011 with the first set of competitive tenders taking place in June 2008. Subsequently on 13 September 2007 Ofgem received a final proposal from the GDNs to amend their charging methodologies so that a greater proportion of revenue was collected from capacity charges.

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[1] The terms “the Authority”, “Ofgem” and “we” are used interchangeably in this document. Ofgem is the Gas and Electricity Markets Authority.
[2] This document also constitutes notice of the reasons for this decision as required by section 38A of the Gas Act 1986.
[3] http://ofgem2.ulcc.ac.uk/temp/ofgem/cache/cmsattach/14067_3806.pdf?wtfrom=/ofgem/whats-new/archive.jsp
[4] http://ofgem2.ulcc.ac.uk/temp/ofgem/cache/cmsattach/11945_17305.pdf?wtfrom=/ofgem/whats-new/archive.jsp
[5] http://www.gasgovernance.com/Code/Modifications/ClosedMods/CM081_090/

On 21 September 2007 Ofgem notified the industry that it intended to carry out a full Regulatory Impact Assessment on the proposal. A draft IA[6] for consultation was published on 30 October 2007 with the closing date for responses being 26 November 2008. 14 responses were received to this consultation and these have informed the final IA published in conjunction with this decision letter.

The modification proposal ("the proposal")

On 13 September 2007 Ofgem received a final proposal from the GDNs to amend their charging methodologies with effect from 1 October 2008 so that:

- the proportion of revenue collected from Use of System capacity charges increases from 50% to 95%, while the proportion collected from Use of System commodity charges decreases from 50% to 5%;

- interruptible supply points pay capacity charges equal to 47.37% of those paid by an equivalent firm connection, so maintaining the existing value of capacity charge discounts received by these supply points.

Justification of the proposal

The GDNs are obliged to keep their charging methodology under review to ensure that the objectives of the charging methodology are being achieved further to Standard Special Condition (SSC) A5 (2A)(a) of the gas transporters' licence ('the licence'). The relevant objectives as outlined under SSC A5 (5) of the licence are as follows;

- to reflect the costs incurred by the licensee in operating its transportation business;

- to take account of changes in the transportation business; and

- to facilitate effective competition between shippers and suppliers.

The GDNs consider that the proposal would result in a more cost reflective structure of charges than is currently the case. The cost information provided by the GDNs as part of the DNPC03 process indicate that the majority of costs relate to the provision of capacity on the network and that only a small proportion directly relate to system throughput.

The GDNs also consider that the proposal will reduce instability in the level of transportation charges as it will align the effect of variations in system throughput on allowed and collected revenues. The GDNs believe this will make charges more predictable facilitating more accurate budgeting by shippers and suppliers. This would improve the efficiency of the gas supply market and stimulate competition.

Responses to DNPC03

The GDNs consulted on the proposal in July 2007 and received 11 responses ten of which were from shippers/suppliers with the other being from Energy Watch. Three shippers supported the proposal on the basis of improved cost reflectivity.

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[6] http://www.ofgem.gov.uk/Networks/GasDistr/GasDistrPol/Documents1/Draft%20Impact%20Assessment%20on%20Cap%20Com%20Split1.pdf

One shipper supported the proposal with respect to large supply points but not with respect to small supply points due to concerns surrounding cash flow risk to domestic suppliers. The majority of respondents either reserved judgement or could not support the proposal on the basis that not enough evidence relating to cost reflectivity was provided in the consultation paper. Concerns were also expressed about the potential impact on the fuel poor and energy efficiency incentives.

Respondents were also concerned that the proposal would transfer cash flow risk from the GDNs to shippers and that such a reduction in risk should be reflected in the transporters price control. On the issue of timing, several shippers were not in favour of a 1 October 2008 implementation date, preferring a later date, primarily due to the effect on existing supply contracts.

Ofgem impact assessment

On 30 October 2007 Ofgem issued a draft impact assessment on the proposal. We received 14 responses of which one was confidential. The four GDN groupings supported the proposal while, of the other ten respondents, six shippers supported the proposal to varying extents and three did not. The proposal was also opposed by the customer representative that responded.

Respondents to the draft IA made the following points with regard to the key issues under consideration.

1. Cost reflectivity

All four GDN respondents believed the proposal was stronger in terms of the cost reflectivity criterion than acknowledged by Ofgem in the draft IA. In particular the respondents considered that the indirect costs, which represent about 30% of total costs, were more related to network capacity than to throughput. The GDNs stated that "formula rates", the largest item in indirect costs, are related to the asset value of the business which in turn is primarily driven by capacity. In addition, "other net overheads", the next largest item in indirect costs, it was suggested are activities typically undertaken in support of the direct cost activities and might therefore be regarded as being capacity related. The main throughput related cost is shrinkage, which requires minimal overhead support. Since the vast majority of direct costs are capacity related, the GDNs contend that overheads such as HR, Finance and IT functions should be recovered on the basis of capacity charges.

Five shippers also believed the proposal would improve cost reflectivity. One of these respondents stated that while they were not convinced that 95:5 is cost reflective, it may still be appropriate to accept this split as a more targeted approach would generate additional implementation costs.

Three shipper respondents were unconvinced that the proposal would result in a more cost reflective charging methodology. One of these respondents believed the GDNs should investigate whether a customer charge is necessary to recover the 30% of costs not directly related to either system capacity or throughput. This respondent also stated that the proposal had not investigated the different costs that different classes of customers place on the system.

Three GDNs believed that those costs identified as indirect costs should be entirely recovered via capacity charges. One stated that allocating such costs to commodity charges would promote a mismatch between allowed and collected revenue and would adversely affect stability in the level of charges. In any case a pro-rata allocation of indirect costs would generate a 93:7 split, similar to the 95:5 split proposed in DNPC03. This respondent also believed a fixed charge per customer would be regressive and costly to administer. Another of these respondents stated that DNPC03 did not claim that 95% of use of system costs were directly related to capacity, but rather that only a small proportion, 5%, are related to throughput and that it is only appropriate for commodity charges to recover these costs.

The fourth GDN believed that a pro-rata allocation of indirect costs should only occur where there was no link between these and capacity, for example in the case of the PGT licence fee. This respondent was of the view however that a large proportion of indirect costs were linked to capacity, for example formula rates. Consequently such an approach would result in a capacity commodity split very similar to that proposed in DNPC03.

2. Changing transportation business

All GDNs were satisfied with Ofgem's assessment that the proposal removes an apparent discrepancy in the regulatory regime given that the volume driver in the price control has now been removed. One stated that since allowed revenue is currently unaffected by system throughput, this suggests a very low ratio of commodity to capacity charges. One shipper said it appeared reasonable to align charges with price control developments such as removal of the volume driver.

3. Facilitating effective competition

All four GDNs agreed with Ofgem's assessment of the proposal in relation to promoting more effective competition between shippers / suppliers by removing a significant cause of charging instability. Two GDNs stated that such instability makes it difficult for shippers to ascertain the true underlying transportation charge they will face. Three GDNs believed the benefits to shippers of more stable charges had not been fully acknowledged in the cost benefit analysis. One was surprised that respondents to DNPC03 and Ofgems information request did not regard more stable charges as delivering any significant benefits.

Two shippers believed the proposal would promote more stable charges and facilitate competition among shippers and suppliers. One shipper however did not believe that the proposal would have an appreciable benefit in facilitating competition. This shipper argued that the degree of variability in charges is only in a small part due to inaccurate projections of throughput. Rather providing more information to shippers to enable them to predict future charges would be more effective.

4. Implementation date

One shipper was in favour of an October 2008 implementation date. However this was conditional on the GDNs providing indicative charges for October 2008 in February 2008, and provided the GDNs are prohibited from making charge changes more than once a year.

Five shippers were opposed to an October 2008 implementation date because it would not provide sufficient time to allow shippers to evaluate fully and respond to the impacts of the change, and reduce the impacts on existing fixed term contracts. Two shippers proposed that a phased implementation may be appropriate.

The Authority's Decision

The authority has considered the issues raised by the modification proposal and Final Modification Report dated 13 September 2007. The Authority has considered and taken into account the responses[7] to the joint GDN consultation DNPC03 and responses to the impact assessment carried out by Ofgem. The Authority has concluded that:

1. **implementation of the modification proposal will better facilitate the achievement of the relevant objectives of the methodology; and**
2. **deciding not to veto the proposal is consistent with the Authority's principal objective and statutory duties[8].**

Reasons for the Authorities decision.

Compliance with the charging methodology results in charges which reflect the costs incurred by the licensee in its transportation business – SSC A5(5)(a)

The cost information provided by the GDNs as part of the DNPC03 process indicated that only a small proportion of costs were related to system throughput (5%) and a larger proportion (95%) were not. Of the non commodity costs, while 62% were designated as being directly related to system capacity, 33%, indirect costs, were not. On this basis Ofgem did not accept that GDNs had proven that 95% of costs were related to system capacity. Therefore cost reflectivity alone did not appear to justify acceptance of the proposal.

In their response to the draft IA GDNs argued that indirect costs could be strongly related to network capacity. In particular "formula rates", approximately half of indirect costs, are closely related to network capacity being as they are dependent on the asset value of the business. The GDNs also argued that since overheads are functions in support of the direct cost activities, it seemed reasonable to allocate them as being capacity related.

The Authority accepts that formula rates are related to network capacity and this does strengthen the case for cost reflectivity. It would seem more difficult to make the same connection between overhead functions such as IT, HR, Finance etc and network capacity. It would appear more reasonable to assume that such costs are fixed, remaining unaffected by either system capacity or throughput. However, given that fixed costs are independent of system throughput, it would appear inappropriate to recover them through commodity-based charges. Commodity-based charges within a regime where allowed revenue is independent of system throughput result in undesirable year on year variability in the level of distribution charge

While the Authority remains to be convinced that the proposal is fully justified on the basis of cost reflectivity alone, the absence of a volume driver from the

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[7] DNPC03 proposal, report and representations can be viewed on the joint office website at http://www.gasgovernance.com/industryinfo/TransportationCharges/Consultations/

[8] The Authority's statutory duties are wider than matters which the panel must take into consideration and are detailed mainly in the Gas Act 1986.

calculation of allowed revenue and the evidence that 95% of costs remain unaffected by system throughput, potentially mean that there are substantial benefits from increasing the capacity element of Use of System charges.

The charging methodology properly takes account of developments in the transportation business – SSC A5(5)(b)

As it has become clear that the majority of costs are independent of throughput, the link in the price control between system throughput and allowed revenue, as expressed by the volume driver, has been steadily weakened. For the price control 2008-13 the volume driver has been removed entirely. A divergence between the effect of throughput on allowed and collected revenues not only suggests a discrepancy in the regulatory regime, but also necessitates continual adjustment of distribution charges to align collected with allowed revenue.

By proposing a reduction in the level of revenue subject to throughput related variation, the GDNs are not only removing an apparent discrepancy in the regulatory regime but also facilitating stability in the level of distribution charges.

Compliance with the charging methodology facilitates effective competition between gas shippers and between gas suppliers – SSC A5(5)(c)

Charges that are more cost reflective will have a beneficial effect on competition because end users are only being charged for the costs they impose upon the system. In addition it is anticipated that the proposal will have a beneficial effect on the predictability of the level of charges. Since DN sales gas distribution charges have shown an increasing degree of variability, as licensees adjust charges to align collected and allowed revenue within the formula year.

Analysis conducted by Ofgem shows how the misalignment between collected and allowed revenue was reduced from 37%, during the 5 year 2002-07 price control, to 35%, for the 1 year 2007-8 price control. This was due to the removal of the volume driver in the price control and the “customer charge” for domestic loads changing from a commodity to a capacity based charge. Implementation of DNPC03 would further reduce this misalignment to only 3.5% from October 2008. The analysis further shows that the proposal would result in the under/over recovery component of the K factor being reduced ten fold. Since under/over recoveries are important drivers of price changes, such a reduction would promote a more stable charging environment year on year.

Greater stability in the level of charges will facilitate competition among shippers and suppliers. It promotes certainty about future costs and reduces the risk of creating arbitrary winners and losers that can have the most negative impacts on small non diversified shippers / suppliers. In particular this permits greater innovation and reduces barriers to market entry, and competition will thus be increased. Greater stability in the level of charges will also be valued by large consumers as it will facilitate business planning.

Distributional effects

Ofgem has carefully considered the distributional effects of this proposal. Charges will increase for domestic supply points in some local distribution zones but will decrease in others. In all cases the change is marginal. For a 20,000 Kwh domestic the maximum increase is in Southern at £2.73 pa, while the maximum decrease is in Wales North at -£3.49 pa. Small industrial commercial supply points will see increased charges but again these increases are marginal. Larger supply points will in general see significant decreases though for an individual supply point this may not be the case depending on the load factor.

Our analysis shows that almost all small business supply points will see small rises in their Use of System charges as a consequence of the proposal. While unwelcome, increases in Use of System charges of the estimated magnitude should have no effect on the sustainability of small business customers. The absolute sums of money involved are small and the effect on business costs will be marginal. Typically for such enterprises energy costs are less than 5% of their cost base. And for supply points of this size Use of System charges are between 10% and 15% of final gas bills.

Our analysis also indicates that Independent Gas Transporters (IGTs) will not be adversely affected by the proposal with Relative Price Control (RPC) charging margins decreasing in some local distribution zones, while increasing in others. In all cases, effects are marginal.

Environment

The impact on customers will differ between non daily metered (NDM) and daily metered (DM) customers.

- Capacity charges to NDM supply points are responsive to variations in annual consumption through the Annual Quantity (AQ) Review process and the use of load factors to calculate supply point Supply Offtake Quantity (SOQ). Therefore end users will continue to have an incentive to reduce consumption. However this linkage is not obvious to the majority of consumers, and only significant changes in annual consumption are reflected in the AQ review process.

- Capacity charges to DM supply points are dependant on measured peak demand and do not vary with annual consumption. Increasing the proportion of capacity-related Use of System charges will therefore reduce the incentive to lower gas consumption.

Use of System charges are approximately 20% of a domestic supply points final gas bill and approximately 2% of gas costs for large industrial commercial supply points. Distribution charges have traditionally been regarded as having only a slight effect on annual consumption. The commodity price of gas will continue to provide by far the stronger incentive to reduce consumption. We do not expect implementation of the proposal to have an adverse impact on incentives to improve energy efficiency.

Security of Supply

More cost reflective charging should have a positive impact on security of supply. As consumers receive more accurate economic signals about the costs their consumption places on the network, a more efficient use of the network will be encouraged. The infrastructure will therefore be better placed to ensure that gas supply reaches end users with more certainty.

In summary, the Authority considers that the proposal better facilitates the relevant objectives of the charging methodology as set out in SSC A5 (5) of the licence. For this reason it is decided that the proposal as set out in DNPC03 shall not be vetoed.

Decision Notice

In accordance with Standard Special Condition A5 of the gas transporters' licence, the Authority has decided not to veto modification proposal DNPC03: LDZ System Charges – Capacity Commodity Split and Interruptible Discounts.

David Gray
Manager Director, Networks

Singed on behalf of the Authority and authorised for that purpose.