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Ref: AW/PW/083

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Dear John

Re: DNPC03 – LDZ system charges Capacity Commodity split and Interruptible Discounts – Draft Impact Assessment

<u>Key Issues</u>

Question 1: – What are respondent's views on our assessment of the proposal against the objectives of the distribution charging methodology?

This is considered under the three objectives listed in Ofgem's Impact assessment:

a) <u>To reflect the costs incurred by the licensee in operating its transportation business</u>

The proposal better reflects the costs incurred by the licensee in operating its transportation business than the current position given that just 5% of the costs have been identified as direct costs. NGN does not agree with Ofgem's view that indirect costs are unaffected by changes in system capacity. In the view of NGN, these costs are more closely related to network capacity than to throughput. For example, Formula Rates, the largest item in indirect costs, is related to network assets and hence are related to network capacity. NGN has not identified any indirect costs which are more closely related to throughput than to capacity.

Ofgem suggests using long run marginal costs instead of average costs. NGN considers that this would be impractical to determine with any degree of accuracy. The marginal cost would be small and the required scaling to reach Allowed Revenue would be large, further exacerbating any inaccuracies.

b) <u>To take account of changes in the transportation business</u>

It is appropriate to aim to align distribution charges to the structure of the price control in order to reduce the risk of a mismatch between Allowed and Collected Revenues, and any resultant instability in unit charges. As Allowed Revenue is now invariant with volume, this suggests a very low ratio of commodity to capacity charges.

c) <u>To facilitate effective competition between shippers and suppliers</u>

The proposal will remove a significant driver of charging instability. Currently, this instability is leading to large price changes each October which makes it difficult for shippers to ascertain the true underlying price. A higher capacity percentage will lead to more stable, more cost reflective prices and hence will provide greater certainty about future prices and promote more effective competition.

Question 2: – What are respondent's views on which elements of Use of System costs are related to system capacity, system throughput or neither?

As described in the Consultation paper DNPC03, NGN considers that the elements of the Use of System costs are apportioned as below:

62% direct capacity costs
5% direct commodity costs
33% indirect costs which are capacity related

The indirect costs are made up of Formula Rates (15%) Other Overheads (12%) Service Agreements (5%) and Licence Fee (1%).

The link between Formula Rates and capacity was discussed earlier. Other Overheads include items such as transportation and plant costs, HR and finance functions, and IT support. These costs are mostly related to Network Assets or to staff numbers, which again are much closer related to network assets than to throughput.

Question 3: – What are respondent's views on how best to recover costs that are neither related to system capacity or system throughput?

In the view of NGN, all costs can be broadly related to either system capacity or system throughput. Ofgem suggests that the indirect costs identified by the GDNs are not related to capacity. If this were the case, alternative charging allocations for these costs could be:

- entirely allocated to capacity;
- entirely allocated to commodity;
- a fixed per customer charge; or
- a pro-rata allocation between commodity and capacity charges.

NGN is of the view that the indirect costs should be entirely allocated to capacity, as we believe that they are most closely related to network capacity.

If these costs were entirely allocated to commodity, this would generate a significant mismatch between Allowed and Collected revenue unless actual throughput demand was exactly as forecast. This would adversely affect price stability.

A fixed per customer charge would be regressive towards small customers and implies that these costs vary directly with customer numbers. This approach would also generate significant additional costs as changes would be required to the billing systems both within xoserve and within all the shippers in order to create a new charging type.

A pro-rata allocation of all the indirect costs in proportion to the direct costs would generate a 93:7 split.

	Cost Split	Indirect Costs pro-rated	Total Allocated Costs
Direct Commodity	5%	2%	**7%**
Direct Capacity	62%	31%	**93%**
Indirect	33%		
	100%	**33%**	**100%**

However, it is clear that Formula Rates are directly related to the assets in the ground and therefore to capacity. Prorating the rest of the indirect costs generates a 94:6 split.

	Cost Split	Other Formula Rates	Other Indirect Costs pro-rated	Total Allocated Costs
Direct Commodity	5%		1%	**6%**
Direct Capacity	62%	15%	17%	**94%**
Formula Rates	15%			
Other Indirect	18%			
	100%	**15%**	**18%**	**100%**

This is very close to the 95:5 split being proposed. NGN considers that the other indirect costs are also directly related to capacity, and that the best way to recover all the costs is via a charging structure that is 5% commodity and 95% capacity.

<u>Distributional Impacts</u>

Question 1: – What are respondent's views on the methodology used to determine the distributional impacts of this proposal?

The methodology used to determine the distributional impacts of this proposal appears to be appropriate. For practical reasons it is necessary to aggregate customers into loadband groups and so few customers would experience exactly the result calculated, however it provides a reasonable view of the likely relative impact.

Broadly, the impact for different customers depends on their load factor relative to the network average. It should, however, be noted that the methodology is based on available data at the time, and will be different by the time of implementation. In particular, activity such as the recent AQ review will change the relative impact on different customers dependent on their new level relative to the rest of the network. It is important that shippers ensure that their customers' AQs are maintained at the correct level.

Question 2: – Can respondents identify any additional impacts that have not been included in our analysis?

NGN is not aware of any additional impacts that have not been included.

Question 3: – How do respondents view the proposal as it relates to interruptible supply points?

NGN considers that the proposal provides a practical, simple and fair solution, at a low cost to shippers, to the issue of interruptible customer charging for the interim period prior to implementation of the new interruption regime. The effective discount to interruptible customers, relative to the equivalent firm charge, is maintained.

<u>Other Impacts</u>

Question 1: – What are respondent's views on our analysis of the impacts that might result from implementation of the proposal?

NGN agrees with Ofgem's assessment of other impacts.

Question 2: – Do respondents have any additional information with regard to possible environmental impacts?

NGN does not have any additional information with regard to possible environmental impacts.

Unintended Consequences

Question 1: – Can respondents identify additional significant unintended consequences?

NGN has not identified any additional significant unintended consequences.

Question 2: – What analysis would respondents like to see with regard to bi-annual adjustments to charges?

Ofgem should assess the improvement in the stability of charges. Currently, prices only set in October have to recover any expected under or over recoveries between actual and allowed revenue in just 6 months resulting in prices too high or too low respectively at the end of the year compared to allowed revenue. This results in over or under recovery in the following 6 months and a potential oscillation in charges which can be seen in the GDN price changes since network sale. Bi-annual charges should result in improved stability of unit charges as an April price change should enable prices to be set at the "correct" level going into the formula year with the October price change an adjustment to reflect six months additional data.

The suggested timings for the bi-annual adjustments are 1 April and 1 October, with prices therefore set around 1 February and 1 August. The likely extent of this improvement in stability relative to the status quo should be analysed. Further stability would be expected if the price change notification period was reduced from 60 to 30 days.

Cost Benefit analysis

Question 1: – Do respondents agree that we have identified all relevant costs and benefits?

NGN is not aware of any relevant costs and benefits which have not been identified

Question 2: – Do respondents believe that our quantification of costs and benefits is correct? Interested parties are requested to provide information about any costs and benefits they can identify, which in turn will inform our final IA?

NGN considers that the quantification of costs and benefits is appropriate.

I hope you find these comments useful and if you wish to discuss any of the issues in more detail then please do not hesitate to contact me.

Yours sincerely

Alex Wiseman
Regulation Director