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DNPC03 - LDZ System Charges Capacity Commodity Split and Interruptible Discounts - Draft Impact Assessment

Dear John,

RWE npower welcomes the opportunity to comment on the above document and does so on behalf of all its licensed gas businesses.

We have grouped our comments and concerns by chapter, as shown below.

Chapter 2

As stated in our response to the DNPC03 consultation, based on evidence provided by DNs it is hard to dispute the fact that 95% of DNs costs appear to be insensitive to the level of system throughput. However, as Ofgem point out, the data does not appear to support DNs assertions that 95% of their costs are directly related to capacity. It is arguable therefore whether allocating indirect costs on the basis of capacity better facilitates the relevant objective of cost reflectivity that is required of transporters charging methodologies, compared to allocating them on the basis of throughput or on the basis of a fixed charge per customer. This is particularly the case for non daily metered customers, who are assumed to have the same load factor within defined load bands and whose level of overall contribution to LDZ system costs will vary by the same amount based on their throughput, regardless of where the capacity/commodity split is set.

On the face of it the most cost reflective allocation would appear to be for 30% of LDZ system costs to charged on a set basis per customer, 65% on a capacity basis and 5% on a commodity basis. However, charging a fixed charge per customer regardless of size may not be consistent with the relevant objective of facilitating competition, or with Ofgem's wider duties, and on this basis it does not seem unreasonable to assume larger customers should proportionally pay a larger share of DNs overall indirect costs than smaller customers. If this assumption is reasonable we would argue this supports changing the capacity/commodity split to 65%/35%, and this now seems preferable to changing the capacity/commodity split to 95%/5%.

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The vast majority of customers have an assumed load factor and so have a linear relationship between their annual consumption and their estimated peak day consumption. Whilst this persists, the extent to which cost reflectivity and network investment efficiency can really be achieved through changes to the capacity/commodity split is questionable. Most customers charges will be influenced solely by their annual consumption, regardless of the capacity/commodity split, and so to apportion indirect charges on the basis of capacity when capacity for most customer is simply a proxy for annual consumption seems a flawed logic.

We recognise that greater stability in the level of charges will help to better facilitate the relevant objective required of transporters charging methodologies to facilitate effective competition between shippers and suppliers. However, the degree of variation there has been in gas distribution charges over the last few years is only in a small part due to inaccurate projections of throughput, and with the proposed removal of the throughput driver the scope for variation caused by inaccurate demand projections diminishes still further. We do not think therefore that changing the capacity/commodity split to 95%/5% will have an appreciable benefit in facilitating competition, whereas providing more information to enable shippers and suppliers to better predict the scale and direction of changes to transportation charges under the current methodology is likely to have a significant benefit in our opinion.

Chapter 3

Analysis contained in this chapter shows that the distributional effects of the proposed changes for domestic customers is modest, particularly by comparison with some of the significant variations in distribution prices we have seen over the last few years. They will however increase the differential that currently exists between the lowest and highest network distribution charges, which could provide further encouragement for suppliers to adopt regional domestic gas tariffs.

When it comes to I&C customers the distributional effects are more substantial. Broadly speaking larger customers benefit most, as one would expect, but the magnitude of this benefit depends on their location and the estimated load factor associated with their EUC band, and how this differs from the network average.

Analysis of the interruptible sector shows that despite the proposals being designed to ensure the interruptible sector as a whole makes the same overall contribution to DN revenue as now, the distributional effects are varied. Whilst we have some reservations about using Bottom Stop SOQ as the basis for the analysis, if you assume this a valid basis it is apparent that there are material differences within each EUC band between those customers that would benefit, and those that would lose out under these proposals. Trying to explain to an very large EUC9B interruptible customer in London area why imposition of an interruption capacity charge should result in them paying £28,000 more per annum, whilst a similar customer in the North East would be paying £47,000 less per annum will not be easy, and demonstrates the flaws in this approach. It is also not clear whether Bottom Stop or booked SOQ will be used as the basis for setting the capacity element of distribution charges.

We do not support the introduction of special interruption capacity charges in October 2008 and believe instead that DNs should implement their enduring interruption arrangements in October 2011, charging full capacity charges to those sites it does not need to be interruptible at this point. If DNs feel they must take steps to make their charges more cost reflective in the interim period, changing the capacity commodity split to 65%/35% would negate some of the windfall benefit that interruptible customers might receive in the interim period. It would also ensure that interruptible customers make an appropriate contribution, based on the extent of their offtake, towards the 30% of DNs costs which are non-capacity related indirect costs.

Finally with regards to IGT customers changing the capacity/commodity split does not seem to have any significant distributional effects, as was once feared, although this is not a reason in itself for doing this. Similarly we would not expect a change in the capacity/commodity split to 65%/35% to have any greater distributional effects.

Chapter 4

Ofgem's statement that use of system charges are approximately 15% of a domestic supply points final bill looks questionable and we believe this figure has been nearer to 20% of late. To this extent Ofgem may have underestimated the effect of distribution charges on gas consumption, although we accept that commodity price is likely to continue to be a far stronger incentive for consumers to reduce consumption.

Whilst a change in the capacity/commodity split will not in its own right lead to the re-introduction of standing charge tariffs to a greater numbers of domestic customers it will lead suppliers to re-evaluate the appropriateness of their tariff structures. The extent to which suppliers do decide to revert back to standing charge tariffs remains to be seen. However, the increasing likelihood and magnitude of exposures arising between collected revenue and charged costs means it would be unwise to rule this eventuality out completely.

Chapter 5

We have previously highlighted how the inadequacies of the current gas settlement systems and processes might exacerbate risk to shippers/suppliers under these proposals. To this extent we welcome the fact that there is currently a considerable amount of work going on reviewing the appropriateness of these systems and processes. It is to be hoped that requisite changes (for example to the current 20% AQ threshold) will be made prior to the introduction of these proposals. However, we fear this will not be the case if implementation were to take place in October 2008, particularly as any change will have to navigate the uncharted waters of xoserve's new User Pays funding approach. Until such time as the current settlement systems and process are properly aligned to reflect a greater emphasis on capacity Ofgem should resist any move to implement these proposals in their current form.

As regards the issue of biannual adjustments to distribution charges, we agree Ofgem are right to defer a decision on this until they have reached a view on the capacity/commodity split. We have previously suggested that it would be appropriate to defer any proposed implementation of this until April 2009 and we maintain this view. The extent to which we would like to see analysis on the effect of bi-annual adjustments to distribution charges is largely dependent on whether or not our modification proposal 160 is implemented. If it is, we do not believe any significant analysis will be necessary as shippers/suppliers will already be getting regular information about costs being incurred and how revenue is being collected against target, and will be able to predict the likely influence these will have on future distribution charges. If it is not, we would expect extensive current and historical analysis of cost and revenue data to be published to inform any future consultation.

Chapter 6

It is hard for us to comment on the adequacy of Ofgem's cost benefit analysis at this stage but we would expect Ofgem to produce a more complete estimate of overall shipper costs in their final impact assessment.

We believe Ofgem are right to exclude shippers/suppliers estimated costs of changing their retail tariff structure as even if this occurs these proposals will be just one of a number of contributing factors in such a decision. This tends to suggest that shippers/suppliers IT costs are likely to be modest, subject to the caveat that xoserve have still not ruled out additional changes to UK Link being required.

Ofgem have assumed, perhaps conveniently, that shippers cashflow risks can be regarded as distributional impacts. We do not believe however that shipper cashflow dis-benefits are equally and oppositely offset by DN cashflow benefits, and as Ofgem concede that these proposals would appear to transfer risk from the DN to the shipper community we would expect Ofgem to attempt to quantify this risk in their final impact assessment, particularly if they assume suppliers will continue to maintain their current retail tariff structures.

Xoserve's estimated costs of £130,000 for applying discounted capacity charges to interruptible customers seems very precise bearing in mind they have not yet announced whether a new file format is necessary, and it is unclear how costs will vary depending on this decision. Whatever the costs however, we would expect these to be met by xoserve as part of their GDPCR funding and not be subject to User Pays.

Should you wish to discuss our response in more detail please do not hesitate to contact me.

Yours sincerely,

Steve Rose
Economic Regulation

Sent by e-mail and therefore not signed