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AW/PW/107

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Ofgem
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Dear Mark

Re: Code Governance Review: Charging Methodology Governance Options

I have pleasure in providing NGN's response to your consultation on charging methodology governance options. Please note that our response is focussed on gas distribution and does not cover other charging methodologies. Indeed, it should be noted that the most appropriate solutions and timescale are likely to differ across industries.

NGN's strong belief is that the current arrangements work well. Since sale in 2005, GDNs have strived to ensure that there is greater transparency of charging methodologies and their impact and that all industry participants can contribute to methodological developments. There is extensive dialogue between GDNs and network users with regular forums, and users have every opportunity to propose changes to charging methodologies. All proposed changes are fully consulted on with the industry and a comprehensive report is produced to enable Ofgem to make an informed decision.

However, if shippers are able to propose modifications directly through the UNC (or alternative arrangements), there is a danger that there will be a proliferation of mods proposed and that these would be polarised, for example domestic shippers proposing mods that reduce domestic costs and I&C shippers proposing mods that reduce I&C costs. There is evidence both of this polarisation and proliferation already with mods 115 and 115a (and the six subsequent related mods) relating to reconciliation of unidentified gas. Consequently options 2, 3 and 4 will introduce additional cost and complexity with no additional benefit. Transporters are independent and are in the best position to judge appropriate non-discriminatory and cost-reflective charging and to consult accordingly. Additionally, revenue is a licence issue with a number of obligations surrounding setting of charges and as such it should be for Ofgem to direct any changes and not for shippers to propose and be able to vote on changes.

We assume that the proposed reforms <u>exclude</u> connection charging methodology which should remain as it is and separate from the transportation charging methodology. Indeed, there is a danger that shippers propose mods which alter what is included and excluded within transportation charging – an example can be seen with mod 232 which seeks (inappropriately) to recover the cost of unidentified gas through transportation charges. Changes to the boundary of transportation charges must be avoided as this could have significant price control implications for networks.

To strengthen current arrangements, NGN proposes that all aspects of the charging methodology are reviewed regularly, say on a rotating five year basis. This will ensure full engagement of the industry on every aspect of the methodology and avoid the piecemeal approach likely if charging methodology was subject to industry code governance.

It is noteworthy that Ofgem's commissioned Brattle report concluded that there are "strong arguments for maintaining the status quo" and that change could entail significant new risks for networks.

The remainder of this response addresses the specific questions in your consultation. I would be happy to meet with you to discuss any of the content in more detail if that would be helpful.

Please note that this response can be regarded as non-confidential.

Yours sincerely

Alex Wiseman
Regulation Director

Code Governance Review: Charging Methodology Governance Options

CHAPTER: Two

Question 1: Are there other key issues that should be considered? If so, what impact would these issues have on NWOs and network users?

Our only comment is that in gas relationships with the industry are strong with useful dialogue on charging methodologies and that if specific measures are needed in electricity it is not necessarily the case that similar measures would be required or appropriate for gas charging methodologies. Whilst there are some similarities between gas and electricity industries, they are intrinsically different industries, facing different cost structures and different relative stakeholder powers.

Question 2: Are there any aspects of the key issues that we have not addressed?

There are no additional aspects that we consider should be addressed.

Question 3: Should Ofgem consider governance arrangements for all charging methodologies on a common timetable, or seek to prioritise? If the latter, which methodologies do you consider should take priority and what would the benefits of this approach be?

There is no rationale for a common timetable between gas and electricity and each should be considered on their own merits and within a timeframe that suits that industry. However, within the gas industry there may be an advantage to considering the transmission and distribution networks at the same time in order to ensure consistency.

CHAPTER: Three

Question 1: Are there alternative governance arrangements that could be considered appropriate for charging methodologies?

In the gas industry, the current governance arrangements are not a static position and they have undergone a fair degree of development since network sale and are continuing to evolve. Consequently option 1 would better be called “current structure”; we support Ofgem’s comments that “there may be incremental improvements that could be made to the charging methodology arrangements whilst preserving the existing regulatory framework”.

Since network sale the Distribution Charging Methodologies Forum (DCMF) has been created and developed to become a valuable industry forum for networks and shippers. At present it is primarily used to present and discuss proposed and live consultations and to present the Mod 186 reports to shippers. These reports have been welcomed by shippers and provides them with the detail that they were seeking on forecast changes to transportation charges.

The DCMF meets at least every 3 months, and shippers are encouraged to bring up discussion of any area of the charging methodology. Additional DCMF meetings can be convened at the request of any GDN or shipper. The DCMF is generally well attended, with between 10 and 15 different shippers and IGTs attending each of the last three meetings (approximately double shipper and IGT attendance at recent Distribution Workstream meetings).

The GDNs have been working their way through the areas of methodology identified by Ofgem in its review of the structure of charges, fully presenting to the industry at industry meetings and consulting on any resultant proposed changes. We envisage that these areas will be revisited periodically to ensure that the parameters surrounding them are still appropriate, along with a review of the fundamental methodology behind them.

The DCMF is a forum where any shipper can put forward any aspect of the methodology that it considers should be reviewed by the GDNs to assess whether it is maintaining its licence obligations with respect to cost reflectivity, enhancing competition or taking into account developments in the industry. This forum could be strengthened so that attendees could discuss and fine tune review proposals to ensure the best quality analysis and vote to agree appropriate scheduling of reviews. In this way GDNs would be held to account by network users whilst at the same time DN workload evaluating such proposals is kept to an agreed reasonable level. Ofgem suggests in paragraph 2.2 “that network users are potentially disadvantaged by the governance processes that underlie the NWOs’ charging methodologies as they cannot formally propose changes to the methodologies”. However, we believe that structures and forums exist now for network users to propose changes.

NGN proposes a methodical approach to reviewing the structure of charges, for example where each element was reviewed on a rotational basis, say every five years. The review would involve full industry consultation. In this way shippers would be fully involved in reviewing every aspect of the structure of charges and the industry can avoid the piecemeal approach likely if anyone could propose mods.

Question 2: Do you agree with our assessment of the options against the principles of the Review? Are there other impacts that we have not mentioned?

The UNC successfully covers the operational interface between network operators and network users. However, wherever there is an opportunity for significant material gains or losses between different groups of shippers, the modification process tends to lead to multiple conflicting Mods being raised, and significant time and energy devoted to dealing with the fallout. An example of this would be the raft of related Mods arising from the issue of the appropriate allocation of unidentified gas, which has so far led to Mods 115, 115A, 194, 194A, 228, 229, 231 and 232. In order to accommodate these Mods, an additional workstream group has been created which will have at least 6 London meetings over the next 6 months. Each of these Mods must be assessed, and relevant analysis done, resulting in significant additional workload. It is very important that these issues be fully investigated and appraised, but the multiple mod proposal format may not do this in the most effective manner. Smaller shippers do not have the resources to carefully assess every alternate Mod in such a situation, and so the representations would be weighted towards the larger shippers.

By definition, all elements of the charging methodology have differing monetary impacts on different shippers. Thus there is a high likelihood that any proposed change to the methodology would result in multiple alternative Mods. As resources will have to be divided across the Mods, the quality of analysis may suffer, and other more important areas of the methodology may receive less attention as focus is trained on the area covered by the latest group of Mods rather than taking a holistic and more structured view.

Specific comments on each of the principles are as follows.

Promotion of inclusive, accessible and effective consultation

The alternatives to the status quo will add cost and complexity with no benefit that is not already achieved through the extensive industry engagement and consultation.

Governed by rules and processes that are transparent and easily understood

The existing process is straightforward and changing the licence or putting charging methodology into the UNC will increase complexity and will not increase understanding beyond that currently being achieved.

Administered in an independent and objective fashion

The transporters have nothing to gain from changes in methodology as allowed revenue is unchanged; consequently transporters are independent and current arrangements are administered independently and objectively. This can be contrasted with the shippers who broadly split into I&C and domestic and can be seen to submit partisan mods. Thus the status quo is the most independent and objective solution.

Rigorous and high quality analysis of the case for and against proposed changes

The consultation process to date has provided very clear, rigorous analysis of proposed changes. It is unclear how this would be improved through changes to current arrangements.

Cost effectiveness

Undoubtedly, as Ofgem points out, costs would increase if arrangements were changed and these are estimated below.

Flexible rules and processes leading to efficient change management

NGN does not believe that change would lead to efficient change management in gas and it is noteworthy that Ofgem in its letter has only used an electricity example. We agree with Ofgem's comment that the additional mods that would arise will reduce efficiency.

Proportionate regulatory burden

There is currently a substantive regulatory burden on networks relating to charging methodology. This is entirely appropriate, but it is unclear that increasing this burden via licence or UNC changes can be regarded as proportionate as it will increase costs and complexity with no commensurate economic benefit.

Question 3: What are your views on the cost and risk mitigation measures set out in this chapter? Are there other mitigation measures that could be introduced?

<u>Annual/biannual windows for change and implementation</u>

This potentially reduces the ability to respond in a timely manner to industry changes, and risks poorly thought out proposals being raised in order to fit the timeframe.

<u>Restriction on numbers of Mods</u>

This would favour larger shippers who had the resources to raise more Mods earlier, and could potentially bar another shipper from raising an alternate mod that would better suit the situation simply because other users had already raised other, poorer quality Mods.

<u>Minimum support threshold for mod</u>

This could prevent small shippers with valid suggestions from being heard, particularly if their mod is not advantageous to other parties. It also encourages shippers to form alliances, supporting one shipper's mod in return for a promise of support back on another mod.

Promotion of inclusive, accessible and effective consultation

NGN does not believe that options 2, 3 or 4 would significantly improve the accessibility of the charging methodologies. Consultation is currently fully inclusive and it is not clear that changing the structure would encourage non-network parties to propose appropriate methodologies. NWOs are in the best position to gauge cost reflectivity and consultations always describe how charging structures maintain or improve cost reflectivity.

Additional questions

1. To the extent that non-network parties are able to formally raise modifications to charging methodologies please give an indication of the impact on your business in terms of increased number of modifications, assessment of additional modifications and regulatory impact. 2. Please give an indication of the costs associated with each of the governance options.

It is impossible to determine whether non-network parties will raise mods but in all likelihood there will be a substantive number of additional mods raised leading to significant increased workload for networks. NGN's assessment is that for options 2, 3 and 4 (when compared to option 1) the analysis required and attendance at the likely addition subgroups formed may require an additional person with a total cost, including on-costs of £60,000 per year. Additionally there is likely to be substantive management time and input which may add an additional £100,000. Option 4 would add further bureaucracy and cost and is our least favoured option.

These cost estimates do not include xoserve scoping and, if the mod is approved, xoserve implementation costs which xoserve estimates could result in costs increasing from around £300,000 per year to over £1m per year.

Please give an indication of the impact on your business of each of the options in relation to price certainty, regulatory uncertainty and project investment.

NGN would recommend that networks have the option of deferring any change to the structure of charges until the following 1 April to coincide with price changes and with the start of the formula year. In this way the changes would be simpler to administer and would not require interim changes to charges. It is unlikely that any material industry benefits will be gained by implementing on alternative dates. In this way, the price and regulatory uncertainty should be small.

Please indicate which of the options poses the least risk to your business activity and why you believe this is the case

As indicated throughout our response we believe option 1 poses the least risk and is also the best option for the industry. Option 1 enables GDNs to manage changes to the structure of charges in a methodical manner whilst ensuring that the charges remain cost reflective and non-discriminatory. Non-GDNs do not have these obligations and so there is a danger under the other options that changes are discriminatory or not cost-reflective.

These risks would be magnified under option 4 if GDNs did not have at least 50% of the new panel membership.