

Modification proposal:	Joint GDN charging modification proposal DNPC05 – Methodology for determining the Balance of Revenue recovery between LDZ System Charges and Customer Charges		
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	08 January 2010	Implementation date:	1 April 2010

Background to the modification proposal

Ofgem conducted a review of the structure of gas transportation charges in 2004³. As part of that review a number of recommendations were made, including revisiting the balance of charges to gas distribution customers between the local distribution zone (LDZ) "system" charges and the "customer" charges.⁴

There are eight gas distribution networks (GDNs), with a geographical region of Britain – their LDZ – where they are required by their licence to provide gas transportation services. In addition there are a number of other gas transportation licensees - Independent Gas Transporters (iGTs) - who are able to operate gas transportation networks but do not have a LDZ specified in their licence.

The proportion of charges recovered respectively from the LDZ system charges and customer charges is currently (and proposed to continue to be) based on an allocation of all GDN costs between the upstream (system) and downstream (customer) network activities. This allocation results in a target percentage of cost to be recovered from system/customer charges. The target percentages for each GDN for 2009/10 are presented in appendix B. The current allocation is based on average cost data for all 8 GDNs from 2003. The use of an average across all GDNs reflects the fact that they were under common ownership at the time of determining the balance of cost recovery⁵.

The GDNs issued a joint consultation on 7th October 2008 (DNPC04) on changes to the methodology for setting the balance between system and customer charges⁶. Following comments from consultation respondents and feedback from Ofgem the GDNs issued a further consultation on 21st October 2009 (DNPC05)⁷. On 15th December 2009 Ofgem received a final proposal from the GDNs to

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 See Ofgem (2004), 'Conclusions on the review of the structure of gas distribution charges'. Link: [Conclusions on the review of the structure of gas distribution charges - More Document Information](#)

⁴ Gas transportation charges consist of two elements, "system" and "customer" charges. Broadly system charges relate to the costs associated with the main distribution system and the customer charges relate to the cost of service pipes and activities associated with customers.

⁵ Since then National Grid has sold 4 of its then 8 networks.

⁶ Consultation paper and responses can be found at: <http://www.gasgovernance.co.uk/DNPC04>

⁷ Consultation paper and responses can be found at: <http://www.gasgovernance.co.uk/dnpc05>

amend their charging methodologies to change the balance of cost recovery between system and customer charges⁸.

The modification proposal (“the proposal”)

The modification proposes no substantive change in the underlying methodology of cost allocation between upstream and downstream network activities. However, significant changes in the underlying data that is used in the cost allocation are proposed. The modification proposes to update this to base the cost allocation on cost data specific to each GDN using an average of data from financial years 2007/08 and 2008/09.

In the modification proposal the GDNs state that ideally more than two years of data would be used to determine the balance of cost recovery, however currently only two years of data are available for which all GDNs have reported cost data in accordance with the regulatory reporting pack (RRP) structure. The RRP reporting structure was introduced (with a standardised reporting format and guidelines) to provide consistency of data reporting across all GDNs. The proposal also states that the balance of cost recovery will be reassessed at the time of a price control review, except in exceptional circumstances.

The main impact of a change in the balance between system and customer charges is on iGT margins. We present analysis of this impact (provided to us by the GDNs along with their modification report) in Appendix A to this letter. The analysis covers the impact on the margins available to iGTs on charges to domestic customers, who represent the vast majority of customer connected to iGT networks. The change in iGT margins ranges between +6.8% and -11.1% at the representative domestic customer sites provided (iGT margins will fall in 7 out of the 8 GDN networks areas – the exception being London). Two iGTs also provided us with analysis of the impact on iGT margins, and this analysis was consistent with that provided by the GDNs.

Changing the balance will also have an impact on the relativity of charges to small and large customers. A change in the balance towards system charges will tend to increase the charges of large customers relative to those of small customers and vice versa. Appendix B to this letter shows the impact that the change the proposal will have on the balance between system and customer costs across all 8 GDNs. This impact should be relatively small.

The GDNs are obliged to keep their charging methodology under review to ensure that the objectives of the charging methodology are being achieved in accordance with Standard Special Condition (SSC) A5 (2A)(a) of the gas transporters’ licence (‘the licence’)⁹. The obligation to review their charging methodologies is placed on all licences. This proposal has been submitted jointly by the GDNs to modify all 8 GDN charging methodologies.

In the modification report the GDNs state that compared with the current method for determining the balance between system and customer costs the proposal will better facilitate:

⁸ [Office of Joint Gas transporters \(DEC 2009\), 'Distribution Networks Pricing Consultation Report on DNPC05'](#)

⁹ The relevant objectives for the purposes of this modification proposal as outlined under SSC A5 (5) of the licence are as follows:

- a) to reflect the costs incurred by the licensee in operating its transportation business;
- b) to take account of changes in the transportation business; and
- c) to facilitate effective competition between shippers and suppliers.

- relevant objective (a) as it uses more up to date cost data that is specific to each GDN and it uses more than one year of cost data;
- relevant objective (b) as it reflects that gas distribution consists of 8 different GDNs which is emphasised by National Grid's sale of some of its networks; and
- relevant objective (c) as it will increase certainty over the balance of cost recovery and this will better facilitate competition in gas supply¹⁰.

Responses to DNPC05

The GDNs consulted on the proposal on 21st October 2009. A detailed review of the responses to the consultation questions can be found in consultation report on the Joint Office of the Gas Transporters website¹¹.

We have thoroughly reviewed the responses to the consultation before coming to our decision. In this review we noted some points made by iGT respondents. These points are outlined below.

- iGTs were not properly consulted on the proposal.
- More than 2 years of cost data should be used to set the balance of cost recovery.
- There will be a substantial impact on iGT margins.
- The current iGT price control arrangements will mean that the changes to the DN charges will tend to result in higher charges to shippers for iGT sites compared with equivalent DN sites.
- There will be a knock on effect on the migration dates for iGT legacy sites to move to relative price control (RPC) charging arrangements.

While we considered all of the consultation responses and noted all of the points raised, the basis for Ofgem's conclusion must be whether the proposal better facilitates the achievement of at least one of the relevant objectives. Ofgem will also have regard to its principal objective and statutory duties as mainly set out in the Gas Act 1986. However, points made about the proposals that do not relate to the relevant objectives will have limited weight in the first instance in our decision-making process. We would, of course, be happy to engage with relevant parties regarding any concerns about the implications of our decision on this proposal.

We have noted the iGTs' argument that they have not been properly consulted but consider that iGTs have had a reasonable opportunity to contribute to the development of the proposal. iGTs have had (and taken) the opportunity to respond to the two consultations on the proposal (the first of which was in October 2008) and to participate in the gas distribution charging methodology forum (DCMF) through which the proposal has been developed.

The Authority's Decision

The Authority has considered the issues raised by the modification proposal and Final Modification Report dated 15 December 2009. The Authority has considered and taken into account the responses to the joint GDN consultation DNPC05. The Authority has concluded that:

- 1. implementation of the modification proposal will better facilitate the achievement of the relevant objectives of the methodology; and**

¹⁰ The rationale is that the increased certainty over transportation charges will aid current (and potential) gas shippers and suppliers in developing tariff options for gas customers.

¹¹ A detailed summary of the responses and the responses themselves can be found at this link: <http://www.gasgovernance.co.uk/dnpc05>

2. deciding not to veto the proposal is consistent with the Authority's principal objective and statutory duties¹².

Reasons for the Authority's 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 GDNs already levy network specific charges reflecting their own network specific costs. It would seem appropriate therefore that the balance of cost recovery between system and customer charges is also network specific to reflect differences in costs between networks. We therefore agree with the GDNs that the move from a national average balance of cost recovery to a network specific average would be more cost reflective than the current arrangements and thereby better facilitates the achievement of relevant objective (a).

We also consider that the use of the more up-to-date data reported to Ofgem using the latest set of regulatory reporting guidelines to calculate the balance of cost recovery is more appropriate than using data from 2003. This will be more reflective of the actual balance of costs on the GDNs' networks currently (and in the immediate future). We consider therefore that the use of more up-to-date data better facilitates the achievement of relevant objective (a).

In cost reflective terms the balance of cost recovery in each year should reflect the cost incurred by a GDN in operating and maintaining the upstream and downstream parts of its network. Gas transportation charges must necessarily be set prior to the year in which they are implemented, therefore the required balance of cost recovery must be estimated. Using up to date actual GDN cost data is a prudent way of doing this.

There is a question as to how many years of cost data should be used to estimate the balance. We, like the GDNs and the majority of consultation respondents, recognise that there can be volatility in cost data from year to year. Therefore it would appear appropriate to use several years of cost data to set the balance of cost recovery. This approach mitigates the impact of any usual factors in a single year on the balance of cost recovery.

Also, like the GDNs and a number of respondents we would prefer that the balance between system and customer charges was set with reference to cost data from more than two years. However we acknowledge that GDNs only have two years of data available under the current RRP reporting format. Given that the proposal is to use GDN specific data, the data is significantly more up-to-date and employs more than one year of data, we consider that the proposal better facilitates the achievement of relevant objective (a)¹³.

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

¹² The Authority's statutory duties are wider than the relevant methodology objectives set out in the GDN's licence and are detailed mainly in the Gas Act 1986.

¹³ We have noted concerns by two shippers regarding the potential impact of changes in National Grid's (NG's) accounting depreciation policy between 07/08 and 08/09. We understand that the changes to asset lives were part of NG's regular 5 yearly review of the accounting policies that it uses to prepare its statutory and regulatory accounts. We have considered the impact of the change on the balance of cost recovery with NG. They have provided us with data which shows that the changes bring their policies more into line with other GDNs and have a limited impact on the balance (between 0.44% and 2.01% across the 4 NG GDNs). Following this clarification we do not consider that the change in policy results in inconsistency of data between 07/08 and 08/09 such that there is an issue with using an average of the 2 years of data. However, we would urge GDNs to be mindful of where changes in reporting policies could significantly impact the balance.

We agree with the GDNs that the proposals to use GDN specific costs takes account of developments in the gas transportation business, as following the sales of 4 of the 8 GDNs by NG there are now 4 separate gas transportation groups each with their own specific costs.

Each network will have had different cost structures under common ownership reflecting its characteristics (although these differences would not be reflected in the balance of cost recovery under the current charging methodology). To the extent there are different cost structures, these differences will be exacerbated to some degree under separate ownership as the networks are run by independent management teams who will take differing approaches to operating the networks. We therefore consider that the proposal, which includes the use of network specific data, better facilitates the achievement of relevant objective (b).

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

We are not convinced that the proposal increases the certainty regarding the balance of cost recovery between system and customer charges. The current balance has been in place for a number of years and could therefore be considered to be certain. We do not therefore consider that the use of more up to date data better facilitates the achievement of relevant objective (c).

In considering the proposal against this objective we took into account the point made by iGTs that there could be differential charges to shippers for equivalent customers connected to iGT and GDN networks. However because of the price control regime for iGTs differential charges for iGTs and GDN customers are already imposed. We do not consider that the proposal will significantly impact the extent of charge differentials. Furthermore, shippers did not raise this issue either at DCMF or in responses to the consultation. Indeed all shipper consultation responses supported updating the target balance of cost recovery.

In addition to the assessment against the relevant objectives we have considered the negative impact on iGT margins. We understand that this will be unwelcome for iGTs. However we note that because of the way the iGT RPC there will be no impact on the margins that iGTs earn from customers already connected to their networks. The impact will be on margins from customers that connect to iGT networks after the proposal has been adopted. We do not consider the impact sufficient to detract from the overall proposal which better meet objectives a) and b).

Decision Notice

In accordance with Standard Special Condition A5 of the gas transporters' licence, the Authority has decided not to veto modification proposal DNPC05 – Methodology for determining the Balance of Revenue recovery between LDZ System Charges and Customer Charges



Rachel Fletcher
Partner, Distribution

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

Appendix A – Impact on iGT Margins at Domestic Sites

GDN	No. Domestic plots connected to iGT network	iGT margin under current	iGT margin under proposed	% change in margin	Assumed AQ	Assumed SOQ
NGN	25	£42.92	£41.57	-3.2%	18000	135
	50	£48.68	£47.45	-2.5%		
	100	£55.91	£54.83	-1.9%		
	200	£62.22	£61.28	-1.5%		
Scotia - Scotland	25	£41.75	£40.78	-2.3%	19000	131
	50	£47.11	£46.23	-1.9%		
	100	£54.21	£53.44	-1.4%		
	200	£60.41	£59.74	-1.1%		
Scotia - Southern	25	£49.10	£47.11	-4.1%	19000	168
	50	£59.59	£57.85	-2.9%		
	100	£68.38	£66.86	-2.2%		
	200	£76.05	£74.72	-1.7%		
WWU	25	£49.91	£48.73	-2.4%	18500	160
	50	£53.84	£52.72	-2.1%		
	100	£61.91	£60.94	-1.6%		
	200	£68.97	£68.12	-1.2%		
NG -West Midlands	25	£45.15	£41.47	-8.1%	18500	155
	50	£53.52	£50.17	-6.3%		
	100	£61.40	£58.37	-4.9%		
	200	£68.29	£65.52	-4.1%		
NG - North West	25	£44.13	£39.21	-11.1%	18500	139
	50	£50.61	£46.07	-9.0%		
	100	£58.10	£53.99	-7.1%		
	200	£64.63	£60.90	-5.8%		
NG - London	25	£45.01	£48.06	6.8%	18500	154
	50	£52.93	£55.72	5.3%		
	100	£60.67	£63.19	4.2%		
	200	£67.43	£69.72	3.4%		
NG - East	25	£43.96	£43.59	-0.8%	18500	153
	50	£51.72	£51.38	-0.7%		
	100	£59.16	£58.85	-0.5%		
	200	£65.66	£65.38	-0.4%		

Appendix B – Impact on balance between system and customer charges of proposal.

The table below is adapted from table 1 and table 2 of the GDNs consultation document of DNCP05.

	Current methodology		Proposed methodology	
	<i>System %</i>	<i>Customer %</i>	<i>System %</i>	<i>Customer %</i>
East of England	70.2	29.8	70.5	29.5
London	70.5	29.5	68.1	31.9
North West	69.7	30.3	73.7	26.3
West Midlands	71.2	28.8	74	26
Scotland	70.2	29.8	71.2	28.8
Southern England	71	29	72.8	27.2
Northern England	69.7	30.3	71.3	28.7
Wales & West	70.6	29.4	71.8	28.2

The proportion of charges recovered through system charges will increase in 7 of the 8 GDN areas. However the scale of the increase will be relatively minor with the average increase being 1.3%, and the largest increase being 2.8%. Therefore the impact on the relativity of charges between large and small customers should reasonably small.