Wales & West House
Spooner Close
Celtic Springs
Coedkernew
Newport NP10 8FZ

Tŷ Wales & West
Spooner Close
Celtic Springs
Coedcernyw
Casnewydd NP10 8FZ

T. 029 2027 8500
F. 0870 1450076
www.wwutilities.co.uk

Joanna Campbell
Ofgem
9 Millbank
London
SW1P 3GE

Dear Joanna,

Ofgem consultation: **Mitigating network charging volatility arising from the price control settlement**

The WWU response is structured in three sections:

- **Section 1 provides a context of our response**
- **Section 2 responds to the five options presented in the consultation**
- **Section 3 provides additional suggestions from WWU that should help mitigate charging volatility and promote predictability of charges.**

<u>Section 1: Context of our response.</u>

Since its inception in 2005, WWU has endeavoured to improve predictability of charges and mitigate charging volatility of Annual Network Allowed Revenues; and the subsequent impact of these charges to Shippers and hence gas consumers.

WWU has also led the innovative early engagement with Shippers and we have played a key role in developing charging principles that have significantly reduced charging volatility.

The five options contained within this consultation appear to target predictability of charges but may have little impact on charging volatility. The new industry arrangements from October 2012 for charging "Exit Capacity" to shippers and hence gas consumers may add specific volatility and unpredictability to Gas Distribution charges.

As we move to the new RIIO regime, there are some key principles that could increase the general volatility of Annual Network Allowed Revenues and hence impact Shippers, commercial gas users and domestic gas users. Areas of risk are:

a) The Annual sharing mechanism that will share underspends and overspends with shippers.

b) Uncertainty over an eight year period of timing of large capital projects and the impacts within a totex regime.

c) Future, non controllable uncertainties that would be "logged up" at a certain point once agreed with the industry regulator.

To address and minimise the impact of charging volatility and also promote predictability we will continue to work with Ofgem, Shippers and Gas consumers (Commercial and Domestic).

Wales & West Utilities Limited
Registered Office:
Wales & West House, Spooner Close, Coedkernew, Newport NP10 8FZ
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Specifically, we can take forward the following actions:

a) We will continue to engage and communicate forecasts of future Network Allowed Revenues with all interested parties on a national and local basis. We will do this through the existing Distribution Network Charging Forum (DCMF) as well as meeting individually with our Commercial and Domestic stakeholders. This engagement will provide visibility of the future changes in an ever increasing complex environment. Whilst this will improve predictability it will not mitigate volatility.

b) We will continue to develop and implement charging principles that will further reduce volatility and ensure these changes are reflective of stakeholder requirements.

c) We will work with industry to ensure our charging obligations are appropriate and allow us the flexibility to take a longer term view. We may require a relaxation of our regulatory obligations to allow us to take this longer term view.

d) We propose a review of the annual sharing mechanism at the mid point review. At this time, we will have four years experience and we think this would be a good point to review the RIIO principles.

e) To reduce volatility we will continue to minimise the number of times we change prices. In recent years we have been able to restrict price changes to one per annum.

In summary, we recognise that annual charging volatility and predictability can be a significant issue for the industry and most importantly for commercial and domestic gas consumers. We will continue to work with all stakeholders to develop industry proposals to minimise the risks during and beyond RIIO GD1.

<u>Section 2: WWU responses to specific consultation questions</u>

The five options put forward in this consultation appear to be targeted at improving the predictability of charges rather than mitigating charging volatility. Predictability of charges will not solve the issue caused by volatile prices.

Below, we respond to the 5 options in terms of their impact on charging predictability and volatility. We also provide some suggested actions which may mitigate volatility and help predictability.

<u>Option 1</u>

Improved information for Suppliers.

WWU Response:-

WWU led the introduction of a quarterly information pack that is now provided on a consistent basis to industry. We continually review this information and we hope this information, as well as the face to face discussions at industry charging forums assist predictability of charges. Whilst we could provide more information, this would not reduce charging volatility.

The two most important factors which affect the degree to which transportation prices move are inflation and the Annual Quantity (AQ) Review; both of which are not known at the time annual prices are set.

Under the AQ Review, Shippers amend their peak day capacity each October. Peak day capacity is used to calculate Capacity charges which comprise 96% of transportation revenue. Therefore any movement in shipper peak day capacity has a significant impact on revenue. We have experienced reductions of varying degrees in peak day capacity over the last 5 years which make it very difficult to estimate when setting transportation prices each April.

Option 2

Restricting the frequency of intra year price changes.

WWU Response:-

This would help to stabilise charges and indeed since the creation of Wales & West we have never changed prices within year. However, the new industry arrangements from October 2012 may increase volatility and make it difficult for Gas Distribution Networks (GDNs) to restrict intra year price changes.

From Oct 2012, GDNS become responsible for the recovery of Exit Capacity charges from the Shippers and hence gas consumers. The costs will be charged from the National Transmission Owner (NTS) to the Gas Distribution Networks and then we will pass through the charges to the shippers. The predictability and volatility of these charges from the NTS operator is something we are concerned about. We have no influence over the NTS charge rates. We fully participate in Transmission charging forums but as an industry, we need to do all we can to minimise the volatility of the NTS prices if we are to minimise the volatility for shippers and gas consumers.

If NTS were to align their price adjustments to the formula year instead of the gas year which they currently do this may eliminate the requirement to change prices within year.

In addition, a relaxation of the over/under recovery parameters laid down in the Gas Distribution Licence may remove the need to change prices more than once per year.

Option 3

Increasing the lag on incentive rewards/penalties that networks recover through Allowed Revenues.

WWU Response:-

Whilst increasing the lag on incentives/rewards would improve the accuracy of the price change prediction, it would not mitigate price volatility. The proposal would also penalise GDNs because it would mean that incentive income earned for “out” performance could not be added to Allowed Revenue and recovered from Shippers at the earliest opportunity. Our specific business plan assumptions on risk have not factored in additional delays to recoverable revenues.

From April 2013 gas distribution will be regulated within the new RIIO framework. The new RIIO framework introduces a 2 year delay to charge changes as a result of network under/over performance against cost incentives. Therefore we think the new RIIO framework addresses the consultation points contained within options 3, 4 and 5.

Option 4

Increasing the lag on adjustments to Allowed Revenues from uncertainty mechanisms

WWU Response:-

Again, this would penalise GDNs, financially, because they wouldn’t be able to recover uncertainty costs at the earliest possible date. The RIIO framework addresses this point.

Option 5

Imposing a cap and collar on changes to Allowed Revenues

WWU response:

We do not support this option and this proposal could actually put networks in breach of the licence charging obligations. As stated earlier, we think the current RIIO framework is adequate to address the predictability of Allowed Revenues.

Section 3: WWU Alternative suggestions:

Question 3.1 Do you have any further suggestions which may lead to charging stability

In addition to the future actions we will take forward as outlined in section 1, we outline some possible actions that industry could consider to assist charging stability.

1). As the annual "shipper AQ Review" is a major factor in influencing price changes it would appear sensible for the industry to set peak day capacity volumes to run for a year from April in line with the formula year. This will take away the uncertainty of not knowing the degree to which peak day capacity will fall from Oct and therefore would remove this additional complication when setting prices each April.

2). Following the industry agreed changes to "Exit reform", Exit Capacity charges are now being recovered by the GDNs. The volatility of Exit Capacity prices charged by N.Grid NTS make it increasingly difficult to remain within the current Gas Distribution Licence over/under recovery tolerance parameters and consequently may result in more than one price change per year.

Exit capacity prices are set by N.Grid NTS in line with the gas year from 1st October. A more stable charging environment could be achieved if N.Grid NTS set Exit Capacity prices from 1st April in line with the Formula Year.

3). In view of the increase in the range of incentives/allowances under RIIO together with the additional complication of volatile Exit Capacity prices it may be appropriate to relax the percentage tolerance parameters applied to over recoveries of Allowed Revenue which currently exist in our Licence. If the Gas Distribution Licence was amended to increase the percentage over recovery of Allowed Revenue from 4% to 6% in any one year and 5% for two consecutive years this could avoid price changes for shippers and gas consumers and enable GDNs to remain within their Licence obligations .

4). To avoid volatile charges and lead to a "smoothing" of price changes it may be better if GDNs were allowed to deliberately over recover. For example, if the price change in the following year may lead to a sharp increase in prices the GDNs could deliberately over recover in the preceding year to minimise the price increase in the following year. Whilst this may have a financial impact in the short term, particularly for the smaller Shippers, it would lead to a less volatile charging regime. However, this would require a licence change.

5). Implementing charging methodologies which will reduce volatility and still remain cost reflective. The Distribution Network Charging Methodology Forum (DNCMF) is currently reviewing a charging proposal developed by the Pricing Managers which aims to revise the methodology for recovering Customer Charges. The proposed revised methodology, which comprises 30% of the GDNs transportation income will, if implemented, result in less volatile charges.

6). To review the annual sharing mechanism at the mid point of the PCR to determine the impact this has had on the level of charging volatility.

Summary:

Predictability and volatility of transportation charges is an issue for some shippers, gas consumers and networks. We are committed to the specific actions within our RIIO business plan[1] (as highlighted in section 1) and we have provided several suggestions within section 3 of this response that could help charging stability.

We are committed to working with the industry to develop proposals that are practicable and balanced for all industry participants. We will review the responses from all industry participants and reflect on these responses in any future proposals we make.

Yours sincerely,

Steve Edwards

Head of Commercial and Regulation

Wales & West Utilities

[1] WWU RIIO Business Plan April 2012 Part B4 Uncertainty mechanisms annex can be found at WWW.WWutilities.co.uk