DISTRIBUTION NETWORKS PRICING CONSULTATION REPORT ON DNPC03

LDZ System Charges Capacity Commodity Split and Interruptible Discounts

1. The DNs' Proposals

In DNPC03 the DNs presented for consultation the proposal that the capacity element of the LDZ system charges should be set to recover 95% of the target revenue from these charges. Following on from this change, it was also proposed that interruptible supply points should pay a proportion of the increased capacity charges so as to maintain the typical value of the discount they receive on the LDZ charges at its current level. This would be an interim solution until the new interruption regime comes fully into effect in October 2011. Respondents were also asked to consider whether they would prefer an implementation date of 1 April 2008 or 1 October 2008.

2. Summary

There were 11 responses – 10 from shippers/suppliers and one from an end user representative.

Shippers/Suppliers	
Centrica	CEN
Corona Energy	CE
EDF Energy	EDF
E.ON UK	EON
Gas de France ESS	GDF
RWE	RWE
Scottish Power	SP
Shell Gas Direct	SGD
Statoil UK	STUK
Total Gas and Power Ltd	TGP
End User Representatives	
Energywatch	EW

The responses are summarised below based on the questions for consultations in the original paper.

3. a) Should the Charging Methodology be changed so that the capacity element of the LDZ system charges is set to recover 95% of the revenue from the LDZ system charges, and the commodity element set to recover 5% of the revenue, compared with the current 50%/50% target split.

3.1 Summary of Responses Received

Respondents views were mixed, with some supportive, some undecided and some opposed. Responses from these three groups are discussed below. However in many cases respondents made similar points irrespective of grouping and these points are discussed by subject below.

Three shippers (GDF, RWE, STUK) supported the proposal on the basis of improved cost reflectivity. GDF also said it would remove an existing cross-subsidy in favour of low load factor sites. RWE supported the proposal subject to Ofgem being happy that it was cost reflective. In addition they said that the contribution of the proposal to price stability would be low because they did not think weather sensitivity was a major source of instability. STUK supported the proposal including treating fixed costs as capacity.

One shipper (EON) supported the proposal with respect to Large Supply Points but not with respect to Small Supply Points. They said competition between gas suppliers could be distorted by the cash-flow effects of transporters passing cash flow risks to domestic sector suppliers. This could be a barrier to new entrants and reduce competition and therefore would be inconsistent with the relevant charging methodology objective to promote competition.

The majority of shippers (CE, EDF, SGD, TGP) and the user representative (EW) either reserved judgement on the proposal or could not support it on the basis that not enough information was provided in the Consultation Paper. Nearly all of these respondents wanted more information to demonstrate cost reflectivity. The user representative (EW) thought the change was not justified without more specific information on how different classes of customers would be affected and particularly whether the fuel poor would be adversely affected.

CE were not convinced that overheads should be capacity costs and questioned whether overheads and other fixed costs were appropriately recovered through capacity charges.

EDF thought the split should be different for different classes of customer, as is the case in electricity. They welcomed more stable charges but were concerned at the effect on the fuel poor and energy efficiency.

Two shippers (CEN,SP) were opposed to the proposal. CEN said the case for the proposal was not proven. They thought allocating all overheads to capacity was as arbitrary as the present 50/50 split and that more indicative price and impact information should be provided, and that there should be some explanation of the differences between networks. They also said that stability of charges within charging periods was of limited value as the proposal does not address stability across charging periods.

SP were not convinced that the majority of costs are not influenced by throughput. They said they were not given sufficient level of detail to understand the justification of the proposals.

Standing charges and energy incentives Several respondents (RWE, CEN, EDF, EW) were concerned that the proposal might encourage suppliers to introduce standing charges which would be bad for energy incentives and would adversely affect load low factor customers and the fuel poor.

AQ Review Process Several respondents (RWE, CEN, EDF, SP), made the point that the AQ review process itself should be reviewed, as AQs are only reviewed once per year and there is a 20% threshold for changes. Both these factors reduce the link between customer behaviour and charges. This could mean that AQs would be slow to respond to changes in consumption and could mean customers being over-charged. EDF thought this might have a particular effect on the fuel poor on PPM meters. SP said that AQs should be open to year round appeals and that the current +/- 20% tolerance should be reduced to allow actual transportation charges to more closely reflect actual usage

Review of Capacity/Commodity Split Two shippers (STUK, TGP) wanted to know if the split would change in the future and if so when.

3.2 DNs' Responses

Provision of Information*:*- The DNs have provided additional information on costs and the impact analysis at recent Distribution Charging Methodology Forums and in the consultation paper itself. The DNs consider that the cost information already provided is sufficient to demonstrate that the proposed 95:5 capacity/commodity split is cost reflective.

An impact analysis has also been provided which shows the impact of the changes by load band. This provides a reasonable indication of the impact on customers within these load bands consistent with the level of analysis provided in previous consultations. The consultation document clearly stated that there would be the same percentage impact on shippers for different sizes of domestic customer and would not vary between large and small domestic loads.

Differences between the Networks are due to the fact that they are starting from slightly different positions and that they all have different average load factors.

Treatment of Overhead Costs:- The DNs' view is that because these costs are more related to the size of the business, e.g. the asset base or the number of customers, than they are to throughput, it is more appropriate to reflect them in capacity-based charges than commodity-based charges. Formula rates for example, are based on a Network's asset and income values, which are more related to the capacity of the system than to throughput, especially as allowed revenue now has no volume driver. Other overhead costs such as Finance or IT are more related to the number of employees of the Network, and this again is more related to the capacity of the network than it is to the throughput.

Different split for different classes of customer:- The gas distribution charging methodology has always been based on a common split of capacity and commodity charges across different classes for customer based on the distribution of costs. There is no evidence that the split of costs is different for different classes of customer. Different classes of customer do impose different unit costs on the system and this is taken into account in the structure of charges.

Standing Charges and Impact on Small Users/Fuel Poor:-Several respondents were concerned about the impact of the proposal on domestic customers and the fuel poor on the basis that the proposals might lead suppliers to introduce standing charges for domestic customers. Transportation charges for small domestic users will still reflect their usage because these users have small AQs and therefore small SOQs. There is no reason therefore for the proposal to have a disproportionate effect on those in fuel poverty. However, this ultimately depends on suppliers and how they choose to structure their gas supply charges.

Energy Efficiency Incentives:- Several respondents said that the proposal would reduce energy efficiency incentives. The Licence obligation on the DNs is to comply with relevant objectives of the transportation charges methodology, the principal one of which is cost reflectivity. Wider issues of incentives to encourage the efficient use of energy should be dealt with as part of a comprehensive energy policy covering oil, gas, coal and electricity

Cash-Flow Risk and Competition:- The DNs do not consider that competition between gas suppliers would be distorted by any change in cash flow risks being transferred from the transporter to domestic sector suppliers. Distribution transportation charges represent only about 20% of a domestic consumer's gas bill and therefore the cash flow impact on suppliers should be limited. Any impacts will be identical (for a given size of domestic portfolio) for all domestic suppliers and therefore should not impact on competition between suppliers.

AQ Issues:- The DNs recognise that the proposed change would make it appropriate to review both the timing and size of AQ amendments and will be considering this with xoserve and the industry. The proposed timing of the methodology change would allow time for this to be considered prior to implementation. However the methodology change would bring benefits with the current AQ process and so the timing of implementation should not be delayed by any AQ review requirements.

Stability of Charges:- The DNs consider that the proposals will make an important contribution to price stability because the different weather sensitivities of collected and allowed revenue over the past price control period was a major source of this instability. In the 2008-2013 price control period, if these proposals go ahead, this sensitivity will have been removed from allowed and very largely removed from collected, making charges much more stable and predictable. The DNs recognise that the proposals will not provide stability across price control periods, but no change to the charging structure can do this. The proposals will improve stability of charges within price control periods, which is as much as can be done using the charging structure. Stability across price control periods depends upon factors beyond the scope of the charging methodology

Review of Capacity/Commodity Split: Once the revised proportions have been decided on and implemented it is not envisaged that there would be any need to change them in the foreseeable future, although the charging methodology will be kept under review as required by the DN Licences.

4. b) Should interruptible supply points pay 47.37% of the increased LDZ capacity charge so as to maintain the value of the discount received by interruptible supply points at its current level, on average?

4.1 Summary of Responses Received

Four shippers (CE, EON, GDF, SGD) gave qualified support to the proposal, mainly on the basis that while it seemed appropriate to continue the current level of discounts to interruptibles, they would have liked more information either about costs or about the impact of the proposals on individual customers. Two shippers (GDF, SGD) said the proposal should be supported by improved SOQ data. GDF also commented that customer education would be necessary which the Networks ought to support.

Three shippers (CEN, RWE, STUK) were against the proposal. CEN thought not enough information was supplied in the paper to allow respondents to confirm that 47.37% was an appropriate percentage and were opposed to the use of an average factor. RWE thought the proposal would have discriminatory effects on interruptible customers depending on Load Factors and which LDZ Exit Zone they are located in. STUK said that interruptibles should continue to receive the full discount on the capacity charges to recognise the benefit these customers are providing to the Network.

Two shippers (EDF, TGP) were undecided about the proposal. EDF said they required further information before they could assess whether the proposal was cost reflective. TGP was concerned that the SOQ data shown in the impact analysis did not appear to be correct and needed to be reviewed.

One shipper (SP) and the User organisation (EW) did not comment specifically on the proposal.

4.2 DNs' Response

Cost reflectivity:- The factor of 47.37% is that required to maintain interruptible discounts at their current level. It is therefore cost reflective to the extent that the existing discount to interruptibles is cost reflective. The derivation of the factor is shown in the appendix.

Given that the enduring arrangements for interruptible services and charges have been determined by UNC Modification 90 it has not been considered appropriate to undertake a fundamental review of the level of interruptible charges for the interim period until the enduring regime is implemented. As such, the proposals seek to maintain the current level of benefits for interruptible transportation relative to firm transportation. The cost reflectivity of the proposal is therefore unchanged in terms of the interruptible discount.

However, the consultation paper has demonstrated that a high proportion of indirect costs will be reflected in the proposed level of capacity charges. Since these indirect costs relate as much to interruptible transportation as to firm transportation it is appropriate for interruptible transportation to incur a proportion of the capacity charges.

Discriminatory effects:– It is true that the impact of the change on interruptible customers will vary depending on their Load Factor, but this is equally true of firm customers. There will also be some variation depending on the Network the supply point is in because the initial capacity/commodity splits in the Networks are not exactly 50:50 and are slightly different from each other because of past price changes. Again this effect will be the same for firm customers. The Exit Zone a supply point is in will make no difference because exit capacity charges are NTS charges which are not affected by this proposal.

SOQ data:- The DNs are aware that the registered SOQs for many interruptible supply points may need to be reviewed. The proposed implementation date allows time for shippers to review and alter the SOQs prior to implementation of the change to interruptible charges

Customer Support – The DNs will be happy to support any customer education which would be helpful.

5. c) Should the change be made with effect from 1 April 2008 or 1 October 2008

5.1 Summary of Responses Received

There was no support for a change from 1 April 2008.

Four shippers (EON, GDF, SGD, STUK) supported implementation on 1 October 2008. SGD expressed disappointment that there was no phased option. STUK's support was conditional on interruptibles continuing to receive the full capacity discounts.

Five shippers (CEN, CE, RWE, SP, TGP) were not in favour of either of the proposed dates. These shippers generally supported an implementation date aligned with the end of the transitional arrangements, October 2011, or a phased introduction up to that date. CEN was against the change in the capacity/commodity split but if it did go ahead they preferred October to align with the gas and AQ years. They did not support any change to the interruptible regime before October 2011. CE said neither date was acceptable, mainly because of SOQ data quality and customer contracts. Both they and RWE said April 2009 would be the earliest acceptable date. SP suggested the change be delayed until October 2012.

The user representative (EW) did not specifically comment on the implementation date.

5.2 DNs' Response

The DNs do not think it would be appropriate to delay the implementation of this change until October 2011. As a change which improves the achievement of the objectives of the charging methodology it should be implemented as soon as is practical. There will also be advantages for shippers and suppliers and consumers in that the sooner the change is implemented the sooner the advantages of increased price stability will be realised. There may also be an advantage in having this change implemented and operational before the larger scale changes of UNC Modifications 90 and 116 become effective in order to limit the number of changes taking place at one time.

The DNs accept that the practicalities of implementation in 2008 make October preferable to April and so propose that the changes to the methodology should be made at October 2008. This should enable the quality of AQ and SOQ data to be improved before the implementation date. It also provides time for shippers and suppliers to review the majority of their customer contracts to take into account the change.

There is no direct link between the proposed methodology changes and the full implementation of the enduring interruptible arrangements in 2011. The DNs therefore see no reason to link the implementation date to that of interruption reform.

6. Other Issues Raised

6.1 Centrica – (Numbers refer to sections in Centrica's response)

5. Timing – CEN would like further explanation of the impact of replacing commodity charges with capacity charges in October. **Response** This will be covered in a separate note

7. Weather Risk: CEN say the reduction of the weather risk for transporters should lead to a reduction in the allowed cost of capital. **Response** All of these issues should be taken account of in the Price Control Review

7. Treatment of K CEN say there is a risk that the smaller under- or over- recoveries remaining as a result of these proposals will be inappropriately targeted to low load factor customers. **Response** The change to a higher proportion of capacity charges in the charging structure does mean that low load factors customers will probably bear a slightly higher proportion of the total charges, and therefore a slightly higher proportion of k, but the effect through k will be minimal.

6.2 Corona Energy

CE commented that they did not know why Ofgem wanted to approve increased fixed charges. **Response** The DNs consider that these proposals do not in themselves mean increased fixed charges.

6.3 EDF

EDF say that the proposal seems contrary to the Warm Homes and Energy Conservation Act 2000. They also wanted clarification of the difference between the figure Ofgem quoted in 49/07 of DNs' costs being 5-10% variable with the current figure of 5% variable. **Response** These are really questions for Ofgem.

6.4 Scottish Power

SP comment on the Ofgem proposal to allow DNs to change charges twice a year price. **Response** This is really a matter for the Ofgem consultation.

6.5 GDF

GDF said they would like to see some retro-fitting of the 95:5 model to demonstrate the effect on prices. **Response** This will be discussed at the DCMF on 17th September 2007.

6.6 RWE

RWE commented that the capacity invoice is paid 4 days earlier than the commodity invoice so that the proposed change could result in a cash flow gain for the transporters.. **Response** The DNs will consult xoserve to see if there is any way of dealing with this unintended gain.

7. Final Proposals

a) The Charging Methodology should be changed so that the capacity element of the LDZ system charges is set to recover 95% of the revenue from the LDZ system charges, and the commodity element set to recover 5% of the revenue.

b) interruptible supply points should pay 47.37% of the increased LDZ capacity charge.

c) The change should be made with effect from 1 October 2008.

Appendix – Determination of the 47.37% factor

Existing Regime	**Capacity**	**Commodity**	**Total**
Firm	50	50	100
Interruptible		50	50
New Regime			
Firm	95	5	100
Interruptible	45	5	50

The 47.37% factor is calculated from 45÷95 = 47.37%.