

DISTRIBUTION NETWORKS PRICING CONSULTATION PAPER DNPC05

Methodology for Determining the Balance of Revenue Recovery between LDZ System Charges and Customer Charges

A consultation paper on behalf of all Distribution Networks

1. Introduction

The current methodology for setting the balance of LDZ System and Customer charges is designed to reflect the balance of costs to which these charges relate. At present, this is based on analysis undertaken several years ago on a national basis across all LDZs. More recent cost analyses by the DNs indicate that the proportions of LDZ System and Customer costs each of them incur differ between the DNs.

The DNs issued a consultation, DNPC04, on 7th October 2008 setting out their proposals concerning these activities and invited comments from the shipper community in accordance with DNs' Licence Standard Special Condition A5.

In January 2009 Ofgem announced that there was to be a Competition Commission investigation into the DNO/IDNO boundary charging issue for electricity DNOs and informed the DNs that this might have some read across to DNPC04. They therefore asked the DNs to delay the submission of a DNPC04 consultation report until they knew if this was the case and if the outcome of the investigation would inform the DNPC04 proposal.

Ofgem subsequently indicated in May 2009 that they no longer thought that the Competition Commission investigation into the DNO/IDNO boundary charging issue would have a significant impact on consideration of any proposal on the DN breakdown of costs.

Ofgem also asked each DN to provide data on the balance of costs related to the LDZ System and Customer charges based on the 2007/8 Formula Year using a cost breakdown consistent with the cost Regulatory Reporting Pack which each DN has been required to provide since FY 2007/8. Ofgem also asked the DNs to restate the original analysis (which was based on 2006/7 data as the most recent available at the time) using the same cost categories to the fullest extent possible (since 2006/7 costs were not reported using identical categories).

Consideration of the responses to DNPC04 has also led the DNs to make some small changes in the proposed manner of allocating costs.

Given the delay in proceeding with the original proposal the DNs decided that it would be beneficial to obtain a further estimate of the cost breakdown between the two areas based on the FY 2008/9 data thereby providing further information on the LDZ System / Customer cost split.

Given the time since the initial consultation and the further analysis which has been undertaken by the DNs since then, the DNs have decided that it is appropriate to consult further on the proposed changes to the charging methodology.

This paper:

- Summarises the responses to the initial DNPC04 consultation paper;
- Outlines the small changes to the cost allocation basis since that utilised within DNPC04;
- Describes the cost analysis using 2007/8 and 2008/9 data;
- Proposes a change to the methodology for determining the balance of revenue recovery between LDZ System charges and Customer charges;
- Sets out the impact of implementing the proposal.

The proposals in this consultation paper are supported by all the DNs.

2. DNPC04 and Consultation Responses

2.1 DNPC04

DNPC04 was issued in October 2008 setting out our proposals for the balance of revenue recovery between LDZ System Charges and Customer Charges. The cost analysis underlying the proposals was based on 2006/7 data, which was the latest data available at the time.

In DNPC04, the DNs proposed that the apportionment of revenue recovery between LDZ System and Customer charges within each DN should be updated to reflect the actual proportion of each DN's costs attributable to each element of its activities. It was also proposed that a rule should be established for the adjustment of the level of the charges each time the charges are reset between periodic cost reviews.

2.2 Responses to DNPC04

There were 13 responses to the consultation, 10 from shippers/suppliers and 3 from independent gas transporters (iGTs). A detailed breakdown of the responses is shown in Appendix C.

A majority of the respondents agreed that the charging methodology should be changed so that the balance between LDZ System charges and Customer charges for each DN is based upon a network-specific estimate of the split of relevant costs, so improving cost-reflectivity. Respondents against the use of a network-specific split cited the benefit of greater stability from using a national average, the complexity of network-specific splits, and the adverse impact on IGTs. These issues are considered further in the updated analysis contained within this paper.

There was a variety of views, with no clear overall preference, on the process for updating the balance of charges, including timing and threshold criteria. The responses indicated that greater clarity was needed regarding the way in which some of the options would work. This paper proposes a clearer timescale for when the split within the methodology would be updated.

Given the delay since DNPC04 the particular question regarding timing of implementation (in April 2009) is now redundant. However, some of the issues raised are relevant with regard to the timing of implementation of the proposal contained within this paper. There was a mixture of views from respondents with a majority favouring greater notice (than 5 months) prior to any implementation. This issue is considered again within this paper.

A number of other issues were raised by respondents including:

- frequency of historical cost reviews
- impact on connections market and RPC migration;
- lack of transparency and rationale for the proposal;
- lack of iGT impact assessment;
- consultation process;
- shrinkage and repex cost analysis process

All these issues are considered within this consultation.

3. DNPC05 – Details of Proposed Changes

This paper proposes three changes to the Charging Methodology:

1. To change the methodology for determining the balance of revenue recovery between LDZ System charges and Customer charges from the current national basis to a DN specific estimate of the split of the relevant costs
2. To assess the balance of costs relating to LDZ System and Customer charges using an average of an appropriate number of years for which data on a consistent basis is available for each network.

3. To review the balance of revenue recovery relating to the LDZ System and Customer charges at the beginning of each new Price Control period, except in exceptional circumstances.

3.1 To change the methodology for determining the balance of revenue recovery between LDZ System charges and Customer charges from the current national basis to a DN specific estimate of the split of the relevant costs

In DNPC04 the issue of whether the charging methodology should be changed so that the balance between LDZ System charges and Customer charges for each DN is based upon a network-specific estimate of the split of relevant costs was consulted on. A majority of respondents to DNPC04 agreed that the charging methodology should be changed so that the balance between LDZ System charges and Customer charges for each DN is based upon a network-specific estimate of the split of relevant costs. Any further views on this issue will be considered in this consultation.

Question 1. Should the charging methodology be changed so that the balance between LDZ System charges and Customer charges for each DN is based on a network specific estimate of the split of relevant costs?

3.2 To base the DN specific cost estimates on an average of an appropriate number of years for which data on a consistent basis is available

Table 1 shows the breakdown of costs by DN between those reflected in the LDZ System charges and those reflected in the Customer charges based on data for 2007/8 and 2008/9, and an average across the two years. This analysis incorporates changes made to the cost allocation process since DNPC04 as detailed in Appendix A.

Table 1. Network Specific LDZ System and Customer Charge Split

	LDZ System			Customer		
	07/8	08/9	Average	07/8	08/9	Average
East of England	68.0%	73.0%	70.5%	32.0%	27.0%	29.5%
London	64.7%	71.5%	68.1%	35.3%	28.5%	31.9%
North West	72.6%	74.8%	73.7%	27.4%	25.2%	26.3%
West Midlands	71.3%	76.7%	74.0%	28.7%	23.3%	26.0%
Scotland	70.1%	72.3%	71.2%	29.9%	27.7%	28.8%
Southern England	71.2%	74.3%	72.8%	28.8%	25.7%	27.2%
Northern England	71.2%	71.3%	71.3%	28.8%	28.7%	28.8%
Wales & West	72.6%	71.0%	71.8%	27.4%	29.0%	28.2%
Average	70.2%	73.1%	71.7%	29.8%	26.9%	28.3%

A split based on cost data for 2006/7 was previously provided in DNPC04. However, reporting of costs to Ofgem using an agreed cost framework and consistent definition of cost categories across DNs was only introduced for the reporting of costs for 2007/8 onwards with the introduction of the present price control arrangements. The cost data for 2006/7 was determined using processes and cost definitions which may vary across DNs and which differ from those used for the reporting of 2007/8 cost data onwards.

The DNs consider that using a network-specific split based on the average cost analysis across two or more recent years provides good cost reflectivity and is preferential to basing the split on the latest year of analysis alone since the cost data for any one year may reflect circumstances particular to just the one year and so not be so suitable for determining the ongoing split of LDZ System and Customer charge revenue.

At present consistent data for two years is available and so, under the proposed methodology, the split would be based on data averaged across these two years. If at the time of the next review consistent data is available for more years then an average across a greater number of recent years is likely to be appropriate.

Question 2 Should the balance of costs relating to LDZ System and Customer charges be assessed using an average of an appropriate number of years for which data on a consistent basis is available for each network? An alternative would be to use the cost analysis for just the latest year available.

3.3 To review the balance of revenue recovery at the beginning of each new Price Control period

In DNPC04 the DNs consulted on whether the split of charges should be rebalanced each time that new charges were set, using the latest available data, or whether the split should only be changed if it deviated from the latest cost-reflective split by more than a set threshold. There were mixed views from the respondents with no clear preference to adopt any of the options presented in the consultation paper. However the use of a fixed threshold was opposed by a majority of respondents. The option of reviewing the cost basis every 5 years, to coincide with the price control period, received the greatest explicit support.

We consider that it would be beneficial to keep the split of charges at the values determined from the present analysis for a number of years rather than to incrementally update it each year. We consider that this approach will provide benefit in terms of predictability of the split of charges and so enhance the ability of suppliers to offer longer-term contracts to customers. Under this approach, the charging methodology will still reflect the costs incurred by the licensees but it will better facilitate effective competition between shippers and between suppliers. It is proposed that, unless there are exceptional circumstances, the proposed split between LDZ System and Customer charges, based on the present analysis, is retained until the analysis is updated. We would expect to update the analysis as soon as practical after the start of the next DN price control period.

Question 3 Should the balance of charges relating to LDZ System and Customer charges be reviewed at the beginning of each Price Control period, except in exceptional circumstances?

4. Other Issues

Some respondents to DNPC04 considered that insufficient information was provided to demonstrate that resulting charges would be cost reflective and that the stability of charges needed further consideration. Some respondents also considered that the use of network-specific split of charges added unnecessary complexity.

The DNs consider that the level of information provided here demonstrates the cost reflectivity of the split of LDZ System and Customer charges if adopted based on these proposals. The proposal to only change the balance of charges when the analysis is updated as soon as practical after the start of the next price control should provide stability in the relative levels of the LDZ System and Customer charges over the next few years.

Given that the level of transportation charges will vary anyway by network we do not consider that using network-specific LDZ System/ Customer splits adds any complexity in respect of the resulting charges.

5. Impact of the Proposed Changes

5.1 2009/10 Forecast Splits

The target balance of the LDZ System and Customer charges has been unchanged since Network Sales. The forecast split of revenue recovery between these charges within each network will change slightly year to year due to changes in the load factors, booked SOQ and demand differences within each network. The estimate of the split of revenue recovery within each network for Formula Year 2009/10 is shown in Table 2. As can be seen, the revenue splits have not deviated significantly in each network since 2005.

Table 2. 2009/10 LDZ System-Customer Charges Revenue Split if Unchanged

	LDZ System	Customer
East of England	70.2%	29.8%
London	70.5%	29.5%
North West	69.7%	30.3%
West Midlands	71.2%	28.8%
Scotland	70.2%	29.8%
Southern England	71.0%	29.0%
Northern England	69.7%	30.3%
Wales & West	70.6%	29.4%

5.2 Impact on Charges

Table 3 shows the impact of the proposed rebalancing, based on DN-specific cost information using the two year average cost basis, by load band. For larger loads, the LDZ System charges are proportionally a more significant element of their transportation charges whereas for smaller (domestic) loads the Customer charges are proportionally more significant. Consequently, an increase in the LDZ System apportionment with a corresponding decrease in the Customer apportionment would be expected to lead to an overall charge reduction for smaller end users and a charge increase to larger users. The scale of the change depends upon the level of rebalancing expected. For example, the relative movement in the rebalancing for East of England DN (Tables 1 and 2) is small and so leads to only a small change to charges whereas the change, and thus impact, is larger for London DN.

Table 3. Proposed LDZ System and Customer Charge Split Impact by Directly Connected Load Bands

Directly Connected Load Band Impact	East of England	London	North West	West Midlands	Scotland	Southern England	Northern England	Wales and West
0-73 MWh	-0.1%	0.6%	-1.0%	-0.8%	-0.3%	-0.4%	-0.4%	-0.4%
73-732 MWh	0.3%	-2.0%	3.5%	2.5%	0.8%	1.6%	1.9%	1.0%
732-5,861 MWh	0.3%	-2.6%	4.5%	3.1%	1.0%	1.9%	1.5%	1.4%
>5,861 MWh Firm	0.4%	-2.7%	4.7%	3.1%	1.1%	1.8%	1.6%	1.4%
Interruptible	0.3%	-2.0%	3.7%	2.5%	0.7%	1.7%	1.2%	1.1%
Large Loads	0.4%	-2.1%	N/A	N/A	N/A	1.9%	1.6%	0.8%

An increase in LDZ System charges will be accompanied by a decrease in Customer charges for transportation to directly connected users and vice versa. However, for transportation to CSEP connected users there is no Customer charge and therefore the netting-off impact between the two charge types does not apply. Consequently, our analysis shows (Table 4) that there will be a more pronounced impact in each network (either positive or negative) on the level of transportation charges to CSEPs relative to the impact on directly-connected loads.

5.3 Impact on CSEPs

We consider that the use of DN-specific LDZ System/ Customer splits should not, on average, impact iGTs adversely relative to the use of a national average split based on the same data. With regard to particular iGT impacts, we understand that a change to the DN charges taking effect from 1 April 2010 would not impact on iGT charges until 1 January 2011 since, under the Relative Price Control, iGT charges are linked to a lagged DN transportation charge level. In addition, we understand that, under the RPC, any change to the DN transportation charge level will only impact on the level of iGT charges for new iGT developments initiated after the change to DN transportation charge levels is implemented. We consider therefore that shippers would have sufficient time to identify the impacts upon charges and iGTs would have sufficient time to enter into and conclude discussions with Ofgem concerning any RPC-related matters that they felt arose as a result of these changes.

Table 4. Proposed LDZ System and Customer Charge Split Impact by CSEP Connected Load bands

CSEP Connected Load Band Impact	East of England	London	North West	West Midlands	Scotland	Southern England	Northern England	Wales and West
0-73 MWh	0.5%	-3.5%	5.7%	3.9%	1.4%	2.8%	2.0%	1.7%
73-732 MWh	0.4%	-3.5%	5.7%	4.0%	1.4%	2.7%	2.0%	1.7%
732-5,861 MWh	0.4%	-3.4%	5.8%	3.9%	1.5%	2.8%	2.0%	1.7%
>5,861 MWh Firm	0.4%	-3.4%	5.8%	4.0%	1.5%	2.8%	2.0%	1.7%
Interruptible	0.4%	N/A	5.7%	N/A	N/A	N/A	2.0%	1.8%
Large Loads	N/A	N/A	N/A	N/A	N/A	N/A	2.0%	N/A

6. Implementation of the change

The implementation of these proposals is not expected to require any system change and it is anticipated that this consultation and any subsequent review by the DNs or Ofgem, if required, could be concluded prior to 1st February 2010 when revised charges would need to be published in accordance with the DNs' code obligations in time for implementation from 1st April 2010.

In response to DNPC04, many respondents wanted to delay the implementation of its proposals. Reasons given were that more time would be necessary fully to pass through changes in charges to their customers and that more time was needed to fully understand the impact on iGT connected customers.

The DNs understand that a change to the DN charges taking effect from 1 April 2010 would not impact on iGT charges until 1 January 2011. DNs believe that shippers would have sufficient time to identify the impacts upon charges and iGTs would have sufficient time to enter into and conclude discussions with Ofgem concerning any RPC-related matters that they felt arose as a result of these changes.

With respect to directly-connected customers, the DNs consider that the benefits of implementing more cost-reflective charges in 2010 rather than waiting to 2011 are likely to outweigh any disadvantages relating to supply contracts where suppliers are not able immediately to pass through the changes in transportation charges.

The DNs consider that, with the delay in implementation of any change to the methodology following the DNPC04 consultation, shippers and iGTs have had a considerable period of time (over a year) to understand and prepare for the impact of any such change. The level of change to the balance of charges arising from this proposal is smaller on average than that which would have arisen from implementation of the DNPC04 proposals.

Question 4

Is there any reason why the proposal should not be implemented from 1st April 2010?

7. Objectives of the Charging Methodology

Any change to the charging methodology should be considered with respect to the achievement of the objectives of the charging methodology, set out in Standard Special Condition A5 of the Gas Transporter Licence. The relevant objectives are:

- (a) That compliance with the charging methodology results in charges which reflect the costs incurred by the licensee in its transportation business;
- (b) That, so far as is consistent with (a), the charging methodology properly takes account of developments in the transportation business;
- (c) That, so far as is consistent with (a) and (b), compliance with the charging methodology facilitates effective competition between gas shippers and between gas suppliers.

(a) Cost Reflectivity

The determination of revenue splits between LDZ System and Customer charges for each DN based upon cost analysis particular to each DN would improve the cost reflectivity of the resulting charges for each DN. We consider that the use of an average across a number of years' cost analysis provides a robust analysis and reduces the dependence upon the costs for a particular year.

(b) Take account of developments within the transportation business

A move to DN specific revenue recovery apportionment would reflect the fact the gas distribution business now consists of eight different networks each with its own cost structure.

(c) Facilitating Competition

The proposed change would provide greater certainty on the split of revenue between the LDZ System and Customer charges. We consider that this greater certainty facilitates competition in gas supply.

8. Questions for Consultation

The DNs are consulting on the adoption of the methodology set out in section 3 to determine the revenue recovery apportionment between LDZ System charges and Customer charges with effect from 1 April 2010. This would result in a specific apportionment percentage for each DN and would result in each DN's structure of charges being more reflective of its costs.

The DNs would welcome respondents' views on the following:

1. Should the methodology for determining the balance of revenue recovery between LDZ System charges and Customer charges be changed from the current national basis to a DN specific estimate of the split of the relevant costs?
2. Should the balance of costs relating to LDZ System and Customer charges be assessed using an average of an appropriate number of years for which data on a consistent basis is available for each network? An alternative would be to use the cost analysis for just the latest year available.
3. Should the balance of charges relating to LDZ System and Customer charges be reviewed at the beginning of each Price Control period, except in exceptional circumstance?
4. Is there any reason why the proposal should not be implemented from 1st April 2010?

Responses to this Consultation Paper should be sent to enquiries@gasgovernance.com to arrive by close of play on 18 November 2009.

Questions on the content of the paper can be directed to any of the following:-

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Appendix A.

Changes to Cost Allocation since DNPC04

This section details the changes made to the cost allocations since that utilised for DNPC04. A full description of the latest cost allocation procedure is provided in Appendix B.

The cost allocations for 2007/8 and 2008/9 use the costs as reported in each DN's Cost Regulatory Reporting Pack (RRP) which is required under each DN's GT Licence. The determination of each DN's costs into the reporting categories determined by Ofgem for the RRP is subject to external audit. The cost allocations used for 2006/7 also used costs reported to Ofgem for that year, however there was no common RRP framework defined by Ofgem in use at the time.

Replacement Expenditure

Initial analysis indicated that the replacement expenditure cost splits varied across years, in part due to varying levels and mix of actual replacement workload undertaken. This is because, for practical reasons, workload can be uneven between one year and the next. However, these variations should be offset over the longer term, as mains replacement targets are set in aggregate for an entire price control period.

In order to achieve a more robust estimate of the ongoing cost split the DN's have therefore based the cost analysis on the assumed levels of mains and services replacement work underlying each of their price controls rather than the actual level achieved in each year and have adjusted the opex underlying the cost allocations accordingly. For consistency, the impact of any mains and services replacement expenditure adjustment on the price control revenue for each year has been taken out.

Shrinkage Costs

In the DNPC04 analysis all shrinkage costs were allocated to LDZ System. This was questioned by one respondent. DN shrinkage costs include own use gas, theft and leakage costs. Own use gas relates to gas costs necessary in managing the flow of gas through the network; for example, fuel used to preheat gas flows at pressure reduction sites. DN's pay the full cost associated with network theft including any theft associated with loads connected to iGT networks. Accordingly, it is still considered appropriate to allocate the costs of Own Use Gas and theft to LDZ System so that transportation charges to all offtake types reflect these costs.

Previously, all leakage costs were allocated to LDZ System since leakage was considered to be largely related to the LDZ mains. We have now been able to identify separately mains and services leakage costs and so these have now been allocated respectively to LDZ System and Customer categories in the analysis for all years.

Emergency Costs

These are costs relating to dealing with internal and external escapes. Costs relating to internal escapes and external escapes on services are allocated to Customer. Costs relating to external escapes on mains are allocated to LDZ System. The costs of no trace external escapes are allocated proportional to the other external escape costs. No breakdown of the costs of dealing with escapes in each category is available each year and so the overall cost is allocated to each category in proportion to the weighted number of jobs in each category. In the DNPC04 analysis a uniform weighting was applied to all jobs. For this analysis we have adopted a higher weighting for all external jobs relative to internal jobs. This higher weighting is based on previous analysis showing external escapes typically take longer than internal escapes; this cost analysis has also been used to derive Emergency Service charges for IGTs and so provides consistency in charging approaches. The impact of adopting the different weighting is to allocate slightly more emergency costs to LDZ System than before.

Appendix B

B1 LDZ System and Customer Definitions

The following definitions have been used in determining the cost allocations between Customer and LDZ System services.

Customer Charges reflect costs relating to service pipes funded by the transporter and the costs of emergency work relating to service pipes and downstream of the DN network (i.e. not including any costs associated with gas mains) and required by the DN to satisfy their Licence obligation in respect of emergency service provision. Service pipe costs include all operational and depreciation costs associated with DN-connected service pipes, these costs also include the replacement of such pipes through the Mains and Services Replacement Program (but no proportion of the costs of replacing any gas mains). The relevant portion of indirect, employee overheads and work management costs of supporting Customer cost activities, based on direct work activity costs have been allocated to the Customer cost category.

LDZ System Charges reflect costs which include the cost of all work relating to assets upstream of the service pipe (including the gas mains to which the service pipes are connected) and those costs associated with managing the flow of gas through the system including capacity management. Accordingly, costs for all activities upstream of service pipes relating to the maintenance, replacement and repair of mains and larger pipes, as well as energy management work such as on storage and the construction of new pipes are included in this cost category. The relevant portion of indirect, employee overheads and work management costs of supporting LDZ System cost activities, based on direct work activity costs have been allocated to the LDZ System cost category. Depreciation costs associated with gas mains and Local Transmission System (LTS) pipes and LDZ System activity assets have been attributed to the LDZ System costs. All odorant and shrinkage costs have been allocated to the LDZ System cost category.

B2 LDZ System and Customer Cost Allocations

The following summary provides an outline of the cost allocations applied by all DNs in determining the Customer / LDZ System cost analysis.

- Repair
- Maintenance
- Service Agreements
- Storage and LTS
- Emergency service
- Work Management (central support activities) and Indirect
- Replacement (within year expenditure)
- Regulatory Depreciation
- Formula Rates
- Licence Fee
- Scaling to Allowed Revenue

Costs associated with the provision of excluded services and de-minimus activities have been excluded as they are not recoverable through DN charges. Only those 'formula' activities and costs as described by the DN Licence and covered by the DN Allowed Revenue have formed part of this review.

Repair

Repair work refers to the gas mains and service pipe repair costs following an emergency incident and the costs of each can be directly identified on DN

accounting systems. Mains repair costs have been allocated to LDZ System category and Service pipe repair costs have been allocated to Customer cost category. It is noted that a number of Service repair incidents attract a contribution from a third party (damage or interference) and these contributions have been set off against the relevant costs. As a result, the only costs included in the calculations are those funded by the transporter.

Maintenance

Wayleaves, leakage control, instrumentation, LDZ metering, and district governor maintenance costs are associated with Mains or LTS pipe and have been allocated to the LDZ System category. Maintenance costs associated with the Mains pipe has been allocated to the LDZ System cost category while the Service pipe maintenance has been allocated to the Customer cost category.

Service Arrangements

A number of services were carried out by National Grid on behalf of the iDNs on a contractual basis. These agreements covered activities including distribution network control activities, gas quality monitoring, call centre management, digitisation of pipe records (Work Management support and strategy activities) and certain IT support (Work management indirect activity). It is noted that each network migrated from the contracted arrangements under different timescales and not all services would apply for each of the iDNs. Where possible operational support service arrangement costs have been split between Customer and LDZ System categories on the basis of the specific operational activities they support and all other costs have been allocated on the split of total direct costs.

For National Grid, the costs of providing these services to the iDNs have been allocated in accordance to the operational activity supported by the contracted arrangement and the costs have therefore been excluded from the analysis of National Grid's cost base in order to ensure that no "double counting" has taken place.

Storage and Local Transmission System (LTS)

Storage and LTS maintenance is associated with upstream network operation and energy balancing. These have been allocated to the LDZ System category.

Emergency Services

Emergency work costs include the cost of operational staff responding to an emergency call. The total emergency cost is a combination of "Internal" related emergency work (downstream of the network and typically within the end users premises) and emergencies either on the Service pipe or the Main pipe and based on an average cost per job. The numbers of jobs by category are listed on DN systems and can be readily identified. The Mains pipe associated emergency jobs have been allocated to the LDZ System cost category while Internal and Service related jobs have been allocated to the Customer cost category.

Work Management and Indirect

Work management refers to departmental costs for central support and strategy activities such as planning, control, project support, operational dispatch, call centre management, pipeline records, complaint management activities, as well as shrinkage and odorant costs. Indirect costs include the costs for running the business such as corporate centre, IS, legal, finance and property management. Where possible, costs have been directly allocated to the appropriate category, for example, shrinkage and odorant costs have been allocated to the LDZ System category. Operational support costs have been split between Customer and LDZ System on the basis of the specific operational activities they support i.e. emergency call centre costs were allocated in accordance to the emergency operational activities. Other costs such as those of a business support nature, for example

Finance, IS and Legal, have been apportioned according to the total cost (including work management costs for certain indirect costs) split between Customer and LDZ System expenditure.

Replacement Expenditure

Initial analysis indicated that the replacement expenditure cost splits varied across years, in part due to varying levels and mix of actual replacement workload undertaken. This is because, for practical reasons, workload can be uneven between one year and the next. However, these variations should be offset over the longer term, as mains replacement targets are set in aggregate for an entire price control period.

In order to achieve a more robust estimate of the ongoing cost split the DNs have therefore based the cost analysis on the assumed levels of mains and services replacement work underlying each of their price controls rather than the actual level achieved in each year and have adjusted the opex underlying the cost allocations accordingly. For consistency, the impact of any mains and services replacement expenditure adjustment on the price control revenue for each year has been taken out.

Regulatory Depreciation

The majority of assets allocated by the accounting depreciation method can be directly attributed to the LDZ System and Customer cost categories by using asset reporting descriptions e.g. asset tag of "mains pipe". Where the costs of assets have been identified as relating to both the LDZ System and Customer activities, for example; vehicles and property, the depreciation cost has been allocated by the relevant operational and emergency work proportional allocation (for operational assets i.e. vehicles, tools and plant) or the relevant operational, emergency plus work management proportions (facilities, buildings and land).

Formula Rates

Formula Rates represent the rentable value of the business and have been set by reference to the network asset value. Consequently, the proportional allocations used for depreciation have been used to allocate the Formula Rates between LDZ System and Customer categories.

Licence Fee Costs

The Licence Fee represents Ofgem's costs charged to the DNs. The cost has been allocated based upon the total LDZ System and Customer cost allocations excluding the Licence Fee and scaling to the Allowed revenue.

Scaling to Allowed Revenue – Investment and Cost of Funding

The difference between the Allowed Revenue and the total costs is the return on asset value and the proportional split used for depreciation has been used to allocate the difference to the LDZ System and Customer categories.

Appendix C

Consultation Responses to DNPC04

C1 In DNPC04 the following specific questions were asked:

1. Should the charging methodology be changed so that the balance between LDZ System charges and Customer charges for each DN is based upon a network-specific estimate of the split of relevant costs?
2. Should the DNs rebalance the LDZ System and Customer each time the level of charges is changed or should DNs rebalance the LDZ System and Customer charges only if the forecast revenue split deviates from the cost-reflective target split by more than a set threshold value, if so the DNs would welcome feedback as to whether the threshold should be set at +/- 1%, 2% or at another level
3. Is there any reason why the proposal should not be implemented from 1st April 2009?

C2 Summary of Responses

There were 13 responses to the consultation: 10 from shippers/suppliers and 3 from independent gas transporters (iGTs).

Shippers/Suppliers	
British Gas	BG
Corona Energy	CE
EDF Energy	EDF
E.ON UK	E.ON
Gas de France ESS	GDF
Gazprom Marketing and Trading	GM&T
RWE	RWE
Scottish and Southern Energy	SSE
Statoil Hydro	STUK
Total Gas and Power Ltd	TGP
Independent Gas Transporters	
ES Pipelines	ESP
GTC	GTS
Independent Pipelines	IPL

The responses are summarised below based on the questions for consultations in the DNPC04.

C3 Question 1. Should the charging methodology be changed so that the balance between LDZ System charges and Customer charges for each DN is based upon a network-specific estimate of the split of relevant costs?

C3.1 Summary of Responses Received

Seven shippers (BG, EDF, E.ON, RWE, SSE, STUK, TGP) supported the proposal to adopt network-specific splits of the relevant costs on the basis of improved cost reflectivity. Two shippers (GDF, GM&T) and three iGTs (ESP, GTC, IPL) did not support the proposal for differing reasons. However, it was noted that while GTC did not support the proposal as a whole, they favoured having network-specific splits of costs. Furthermore, GM&T said that they had no issue with the principle of the proposal but did not believe sufficient information was given to demonstrate costs were reflective. One shipper (CE) gave no response to the question.

BG and RWE supported network-specific cost splits but also noted that an update to the national average would be more cost reflective than the current split. BG also said that the national average update ought to be implemented in April 2009 as an interim update if the proposal to adopt a network-specific split basis is delayed.

EDF noted that as DNs already have network-specific charges and shippers have systems and processes in place to support such charges, there would be no process and system issues for shippers and suppliers.

ESP preferred a national average split of costs in order to minimise complexity and the potential for DNs to update the cost basis at different times in the future.

GDF said that, while charges should be cost reflective, consideration should be given to stability and predictability within the charging methodology. GDF also said that the change appeared to be minor and, as such, there was no compelling case to change the terms of the cost reflectivity over stability at this point in time.

IPL did not support the network-specific split of costs as a result of the impacts of the proposal on iGTs and iGT customers. Specifically, IPL noted that the iGT income would be adversely affected and that iGT customers would likely face increased charges compared with similar loads that are directly connected to the DN network.

C4 Question 2. Should the DNs rebalance the LDZ System and Customer charges each time the level of charges is changed or should DNs rebalance the LDZ System and Customer charges only if the forecast revenue split deviates from the cost-reflective target split by more than a set threshold value, if so the DNs would welcome feedback as to whether the threshold should be set at +/- 1%, 2% or at another level.

C4.1 Summary of Responses Received

There were mixed views from the respondents with no clear preference to adopt any of the three options presented in the consultation paper.

One shipper (EDF) and two iGTs (ESP, GTC) favoured rebalancing the LDZ System and Customer charges only if the forecast revenue split deviates from the cost reflective target split by more than the set threshold.

Two shippers (GDF, CE) gave no response to the question and one other (GM&T) said this was a matter for the DNs to consider.

Six shippers and one iGTs did not agree with the proposal to rebalance the LDZ System and Customer charges only if the forecast revenue split deviates from the cost reflective target split by more than the set threshold (BG, E.ON, RWE, SSE, STUK, TGP, IPL). The reasons why the respondents did not support the threshold rebalancing option varied between respondents with some preferring annual rebalancing and some preferring to set the level of charges only when the cost split analysis is updated.

EDF and GTC said that a threshold may be adopted between periodic cost reviews to maintain stability and cost reflectivity; however, EDF suggested a tolerance of +/-3% so that any other methodology changes would not trigger a rebalance. ESP believes that it is appropriate to set a threshold in order to maintain stability and predictability but had no views on the level of the tolerance and said consideration should be given to the materiality of the change against the cost of implementing the change for all parties. One shipper (GM&T) said that DNs should also ensure

the timing of any rebalancing should not distort competition in the shipper/supply market.

EDF, E.ON, STUK, GTC and IPL said that subsequent cost analysis ought to be carried out to coincide with the DN price control (every 5 years). IPL said that a cost analysis every 5 years would enable iGTs to plan future investments more effectively and reduce the administrative burden when carrying out investment appraisals.

BG said that an arbitrary threshold should not be introduced as small changes can have a material impact. BG did not suggest any alternative preference but suggested that if a threshold were to be introduced it should be no greater than 0.5%. Another shipper (SSE) noted that price stability and the need to avoid constantly changing charges are preferable but there was a need to avoid infrequent large step changes. DNs understand that both shippers prefer an annual rebalance.

One shipper (TGP) preferred to maintain the status quo whereby any future rebalancing would be made at the discretion of the DNs providing sufficient time was given to factor changes into shipper charges. RWE said that DNs should not be required to rebalance each year or when charges are changed.

C5 Question 3. Is there any reason why the proposal should not be implemented from 1st April 2009?

C5.1 Summary of Responses Received

Two shippers (BG, RWE) said there was no reason why the proposal should not be implemented from 1 April 2009. BG noted that these parameters used to be updated annually and that the impact is relatively minor when compared to previous methodology changes. BG said that the methodology change removes a cross subsidy in the market which should be considered in the timing of implementation.

Four shippers (EDF, GDF, GM&T, TGP) said that more time would be necessary fully to pass through changes in charges to their customers. GDF and GM&T suggested that implementing the methodology change from 1 April 2009 would distort competition between industrial and commercial shippers that have annual fixed contracts.

SSE was concerned by the short timescales and questioned whether DNs could raise a proposal impacting on charges after the indicative notice period.

iGT respondents have raised several concerns and have all suggested that the proposal should be delayed. ESP, GTC and IPL said that the impacts on iGTs and customers connected to their networks have not been appropriately considered. ESP and GTC also said that the consultation period was insufficient to carry out a detailed review of the impacts. Four shippers (CE, E.ON, GDF, STUK) have also highlighted the need to fully understand the impact on iGT connected customers and suggested delaying implementation until the full impact was known. E.ON suggested delaying the implementation until October 2009. E.ON said that amendments to the RPC mechanism should be considered to avoid excessive transportation charges to iGT connected customers. However, one shipper (EDF) questioned whether the RPC impacts should be within the scope of the consultation and whether the issues raised as a consequence of the proposal are issues related to how RPC has been set.

Two shippers (CE, GDF) and two iGTs (ESP, GTC) suggested combining the proposed methodology change with expected methodology changes relating to the

structure of the LDZ System and Customer charges themselves so as to avoid “piece meal” methodology changes. GM&T expressed their disappointment with the “piecemeal” approach to charge methodology changes.

C6 Other Issues Raised

C6.1 Frequency of Historic Reviews and Charge split levels

BG noted that in the past these parameters had been reviewed on an annual basis without formal consultation.

BG also noted that, in practice, charges have been rounded to 70:30 split and that such a rounding was arbitrary given that it was not widely consulted upon.

C6.2 Impact on Connections Market and RPC Migration

TGP said that the impact of the proposal would introduce an iGT “margin squeeze which then reduces their opportunity to bid for new connections thereby potentially limiting competition”. GTC alleged that DNs occupy a dominant position in the market, and had failed to consider the impacts their proposals could have on competition. Similar comments were received by ESP and IPL.

ESP suggest that this impact could be avoided either by setting iGT allowances against legacy cost levels or by adjusting the DN CSEP charge parameters.

ESP, GTC and IPL said that the proposal would delay the migration of legacy portfolios onto the RPC arrangements and lead to higher RPC prices for some legacy loads. This could lead to a different treatment by shippers of legacy loads than future RPC loads and potentially lead to higher iGT surcharges.

C6.3 Transparency, Rationale and Justification behind the Proposal

GTC said the DN proposal lacked sufficient transparency in explaining the rationale and justification behind the proposals. Furthermore, GTC and IPL said that DNs had not demonstrated why the proposal more closely achieves the relevant methodology objectives.

C6.4 iGT Impact Assessment

GTC and IPL said that DNs had failed to carry out an impact assessment on iGT organisations. IPL also noted that DNs had failed to comply with the Competition Act 1998 in setting their LDZ charges with particular reference to carrying out an assessment of the stand-alone costs of a notional downstream distribution company.

C6.5 Consultation Period and Engagement with iGTs

GTC said there were disappointed that DNs had failed to engage with iGTs and only gave a short period of time to carry out an impact assessment as part of the consultation.

C6.6 Repex and Shrinkage Analysis

IPL raised some concerns with regard to how robust the DN cost analysis carried out was. In particular, IPL question the split of costs for repex allowances and shrinkage.

IPL and GTC questioned why only one year was used as part of the cost analysis, why no comparison on a like for like basis has been provided to historic cost splits and whether a view of future costs could have been considered. IPL said that a more robust analysis should have included a demonstration of Activity Based Costing (ABC).