DISTRIBUTION NETWORKS PRICING CONSULTATION PAPER DNPC07

LDZ System Charges Capacity Commodity Split

A Consultation Paper on behalf of all Distribution Networks

1. Background

In DNPC03, published in July 2007, 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, and the commodity element only 5%. Following consultation this proposal was not vetoed by Ofgem and was implemented by all the DNs with effect from 1 October 2008.

The cost analysis which supported the capacity commodity split of 95/5 is shown below:-

DNPC03 Analysis of costs reflected in the LDZ system charges

	DN Weighted Average	Wales & West Utilities	Scotia Gas Networks	Northern Gas Networks	National Grid
Direct Costs	%	%	%	%	%
Operational costs	21	20	23	17	22
Repex 50%	20	16	15	27	21
Depreciation	22	24	22	17	23
Total Direct Capacity costs	**63**	**60**	60	**61**	**66**
Shrinkage & Odorant	5	5	6	5	4
Total Direct Commodity Costs	**5**	**5**	**6**	**5**	**4**
Total Direct Capacity & Commodity	**68**	**65**	**66**	**66**	**71**
Indirect Costs					
Formula Rates	15	12	14	19	16
PGT Licence Fee	1	1	1	1	1
Service Agreements	3	6	6	5	0
Other Net Overheads	13	17	13	10	13
Total Indirect Capacity Costs	**32**	**36**	**34**	**34**	**29**
Total Direct & Indirect Costs	**100**	**100**	**100**	**100**	**100**
Total Direct Commodity Costs	**5**	**5**	**6**	**5**	**4**
Total Direct & Indirect Capacity Costs	**95**	**95**	**94**	**95**	**96**
Total Direct & Indirect Costs	**100**	**100**	**100**	**100**	**100**

This analysis showed that for all the DNs only a small proportion of the cost reflected in the LDZ system charges, on average about 5%, was related to throughput (commodity) and the rest were capacity related costs or fixed overheads which are more appropriately recovered through capacity charges, as they do not vary with throughput.

At the time of the consultation throughput-related (commodity) costs represented on average 5% of the total direct plus indirect costs reflected in the LDZ system charges. On average 63% of the costs were direct capacity related costs such as depreciation and replacement expenditure which are directly related to the capacity of the system, and operational costs which are again more related to the capacity of the system rather than throughput. Of the 32% indirect costs none are throughput related.

The Commodity element of the costs averaged 5% across the DNs, made up of shrinkage and odorant, with shrinkage accounting for the bulk of these costs. When this analysis was carried out the volume of shrinkage gas was calculated as a percentage of total throughput under the Price Control in force at the time. It was therefore appropriate to treat shrinkage as a commodity-related cost because it varied with throughput.

2. Price Control 2008 - 2013
In the price control which started in April 2008 a fixed shrinkage volume for each Network in GWhs for each year of the Price Control was published in the Licence (Annex O). Setting fixed volumes was based on Ofgem's view that the available evidence showed little correlation between shrinkage and throughput for the existing Networks. The volume of shrinkage therefore became a fixed volume for each year and was no longer linked to throughput. It would therefore now be more cost reflective to treat shrinkage as a fixed cost rather than a commodity cost and to reflect it in the level of capacity charges, in the same way as other costs not related to throughput..

Odorant accounts for only about a quarter of one percent of costs in most DNs and therefore it is considered that it would not be worthwhile to reflect it alone in a commodity element. Therefore it is proposed that the commodity element of the capacity/commodity split should be set to 0% and the capacity element be set to 100%. Within the billing system the commodity charge types will be retained, but with the rates set to zero, so that the option to re-introduce commodity charges is retained.

3. Impact of the Proposed Change
Since the commodity element of the LDZ system charges is already small, at 5%, it is not envisaged that there would be any significant impacts on firm or interruptible supply points. However the way that interruptible charges are calculated would need to be changed, because removing the 5% commodity element would reduce their charges unless there is a corresponding change to the level of the LDZ System interruptible capacity charge as a proportion of the firm capacity charge. Currently this proportion is 47.37% of the LDZ System firm capacity charge which combined with the 5% commodity charge means that interruptibles pay 50% of the equivalent firm LDZ System charges. If the commodity element of the LDZ System charges is set to zero then to maintain the current discount for interruptibles the percentage of the firm capacity charges that they pay would need to be increased to 50%. This should mean no significant change in the transportation charges paid by interruptible supply points.

This change to the percentage of the firm capacity charge paid by interruptible supply points would operate for only six months from April 2011 because all supply points will become firm with effect from 1 October 2011

The average impact of the proposed change by load band and Network is shown in Appendix 1.

4. Implementation of the Change
It is planned that the proposed change would be implemented on 1 April 2011, the same time as the new LDZ System charges proposed in DNPC0X are planned to be implemented. Implementing both changes at the same time would mean that the new structure of LDZ system Charges needs to consist only of LDZ Capacity charge functions – there is no need for separate LDZ Commodity charge functions. This will represent a significant simplification of the charging methodology.

5. Objectives of the Charging Methodology
The proposed change to the capacity / commodity split would involve a change to the charging methodology, and therefore needs to be considered with respect to the achievement of the objectives of the charging methodology, set out in Standard Special Condition 5 of the Gas Transporter Licence. The objectives for charges not set by auction 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
Under the current Price Control shrinkage is no longer a commodity-related cost and therefore it would be more cost reflective to treat it as for other non-commodity related costs i.e. be reflected in the proportion of capacity-related charges.

b) Taking Account of Developments in the Transportation Business

The proposed change in the Methodology would take account of the change in the regulatory treatment of shrinkage in the current Price control compared with the previous Price Control..

6 . Questions for Consultation

The questions for consultation are:

1. Should the Charging Methodology be changed so that the capacity element of the LDZ System charges is set to recover 100% of the revenue from the LDZ system charges, and the commodity element is set to zero, compared with the current 95%/5% target split?

2. Should Interruptible supply points pay 50% of the firm LDZ System capacity charge so as to maintain the value of the discount received by interruptible supply points at its current level, on average?

3. Should this change be made with effect from 1st April 2011?

7. Responses

Responses to this Consultation Paper should be sent to enquiries@gasgovernance.co.uk to arrive by close of play on Friday 28th May 2010.

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

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Appendix 1.
Average Impact of Proposed Changes by Load Band
(Percentage changes are based on the impact on the level of total charges)

	Wales and West Utilities		Northern Gas Networks		Southern (SGN)		Scotland (SGN)	
Load Band (MWh)	Load Factor	Charge Difference	Load Factor	Charge Difference	Load Factor	Charge Difference	Load Factor	Charge Difference
0 - 73.2	32.8%	0.1%	34.9%	0.0%	31.0%	0.0%	39.7%	-0.1%
73.2 - 146.5	30.3%	0.5%	29.3%	0.0%	31.1%	0.7%	40.9%	0.6%
146.5 - 293.1	30.0%	0.6%	29.3%	0.8%	31.1%	1.0%	40.6%	0.9%
293.1 - 439.6	31.0%	0.4%	32.1%	0.6%	30.4%	1.1%	39.3%	1.2%
439.6 - 586	32.0%	0.3%	32.4%	0.5%	31.3%	1.0%	40.5%	1.2%
586 - 732	32.7%	0.2%	33.6%	0.2%	31.5%	1.0%	41.5%	1.2%
732 - 2198	33.1%	0.3%	33.4%	0.8%	31.5%	1.0%	42.3%	1.4%
2198 - 2931	35.8%	0.0%	34.7%	0.3%	27.9%	1.5%	43.2%	1.4%
2931 - 5861	39.2%	-0.4%	37.4%	0.2%	35.5%	0.9%	43.5%	1.6%
Firm								
5861 - 14654	47.5%	-1.4%	44.1%	-0.4%	41.4%	0.8%	50.4%	1.1%
14654 - 29307	43.7%	-0.7%	45.1%	-0.7%	44.1%	0.6%	54.4%	0.5%
29307 - 58614	46.4%	-0.9%	57.6%	-1.7%	51.3%	-0.3%	51.0%	1.2%
58614 - 293071	54.8%	-1.8%	44.2%	0.1%	43.1%	-0.1%	55.7%	-0.3%
293071 - 1465355	75.9%	-4.0%	86.5%	-4.9%	74.0%	-3.4%	40.4%	0.9%
Interruptible								
5861 - 14654	32.0%	-3.5%	30.1%	2.1%	19.4%	-1.5%	49.9%	-5.8%
14654 - 29307	34.0%	-3.8%	30.1%	1.7%	40.1%	-6.9%	62.0%	-8.0%
29307 - 58614	43.9%	-6.0%	44.5%	-1.0%	50.5%	-9.6%	46.8%	-5.0%
58614 - 293071	50.2%	-7.1%	55.7%	-3.3%	32.1%	-4.8%	70.6%	-9.1%
293071 - 1465355	56.1%	-7.8%	81.5%	-7.0%	84.2%	-17.0%	51.8%	-5.1%

	East of England (N Grid)		London (N Grid)		North West (N Grid)		West Midlands (N Grid)	
Load Band (MWh)	Load Factor	Charge Difference	Load Factor	Charge Difference	Load Factor	Charge Difference	Load Factor	Charge Difference
0 - 73.2	34.4%	0.3%	33.0%	0.1%	36.5%	0.6%	32.6%	0.1%
73.2 - 146.5	31.3%	0.5%	33.5%	-0.2%	32.4%	1.1%	29.9%	0.1%
146.5 - 293.1	31.0%	0.5%	33.5%	-0.2%	33.4%	1.0%	29.9%	0.1%
293.1 - 439.6	32.0%	0.4%	33.0%	-0.1%	32.5%	1.1%	27.2%	0.5%
439.6 - 586	33.1%	0.2%	33.2%	-0.2%	34.1%	0.9%	28.1%	0.4%
586 - 732	33.1%	0.2%	34.2%	-0.3%	33.5%	0.9%	27.7%	0.5%
732 - 2198	33.3%	0.7%	35.7%	0.1%	34.1%	1.5%	28.2%	0.8%
2198 - 2931	38.9%	0.2%	39.6%	-0.2%	38.2%	0.9%	35.5%	0.2%
2931 - 5861	39.1%	0.0%	40.1%	-0.2%	39.1%	0.8%	36.7%	-0.1%
Firm								
5861 - 14654	44.5%	-0.5%	39.5%	0.3%	48.2%	-0.3%	41.0%	-1.1%
14654 - 29307	45.6%	-0.5%	47.0%	-0.5%	44.0%	0.4%	49.2%	-2.1%
29307 - 58614	48.2%	-0.7%	51.5%	-0.8%	43.3%	0.6%	51.9%	-2.2%
58614 - 293071	48.9%	-0.2%	44.4%	0.2%	59.2%	-0.5%	43.8%	-1.0%
293071 - 1465355	73.1%	-1.6%	66.2%	-2.1%	n/a	n/a	n/a	n/a
Interruptible								
5861 - 14654	29.8%	1.8%	26.0%	3.0%	36.0%	-3.2%	30.6%	2.4%
14654 - 29307	39.8%	-0.7%	41.4%	-0.3%	30.2%	-1.6%	32.5%	2.1%
29307 - 58614	40.6%	-0.3%	33.0%	1.7%	41.6%	-3.8%	44.8%	-0.3%
58614 - 293071	44.5%	-2.1%	23.0%	2.6%	41.9%	-3.8%	50.2%	-1.0%
293071 - 1465355	66.4%	-4.9%	72.3%	-5.5%	69.3%	-8.7%	69.2%	-6.2%