Modification proposal:	**Distribution Network Pricing Consultation (DNPC 07) – LDZ System Charges Capacity Commodity Split**		
Decision:	The Authority[1] directs that DNPC07 is vetoed[2]		
Target audience:	Gas Distribution Network Operators, the UNC Panel, Parties to the UNC and other interested parties		
Date of publication:	27 January 2011	Implementation Date:	n/a

Background to the proposed modification

The transportation charges levied by gas distribution networks (GDNs) for use of their networks are split into two components; the system charges and the customer charge. Broadly the system charges are intended to recover the cost of the upstream network whilst the customer charge is intended to recover the cost of the local network and customer related costs. Roughly 70 per cent of the transportation part of a customer's bill is the system charge with the remainder being the customer charge.

The GDN methodology for calculating system charges allocates total network cost to pressure tiers and then to four broad categories of customer.[3] These categories are based on the average point of connection[4] of customers within each category and their utilisation of the network tier at peak times. These costs are then charged to customers within these broad categories on the basis of the amount of network capacity they have booked (the capacity charge) and the volume of gas they consume (the commodity charge). The recovery of GDNs' allowed revenue through the system charges is based on an agreed split between the capacity and commodity charge.

On 13 December 2007, Ofgem decided not to veto DNPC03 which was a proposal to revise the split in revenue recovery between capacity and commodity charges from 50:50 to 95:5 respectively. The change in the split of revenue recovery through system charges was based on analysis that showed very little of the GDNs' costs were driven by gas throughput (otherwise referred to as commodity). DNPC03 argued that as most of the costs were fixed it was more appropriate that they were recovered through the fixed capacity charge. The analysis identified that shrinkage and odorant were the only costs related to throughput and contributed between 4 and 6 per cent of total GDN costs. Shrinkage costs were related to throughput because the price control mechanism in operation at that time set target shrinkage volumes as a proportion of throughput.

DNPC03 also argued that reducing the proportion of commodity based charges would reduce the volatility of overall system charges because there would be less need to change charges to account for differences between actual and forecast revenue. It was considered that increasing the predictability of the amounts charged to shippers for transportation would facilitate competition among shippers and suppliers.

[1] The terms 'the Authority', 'Ofgem' and 'we' are used interchangeably in this document. Ofgem is the Office of the Gas and Electricity Markets Authority.
[2] This document is notice of the reasons for this decision as required by section 49A of the Electricity Act 1989.
[3] These are: 0-73.2 MWH/a; 73.2-732MWh/a; over 732MWh/a and interruptible customers.

[4] Ie on average the pressure tier to which customers in each category are connected,

We decided not to veto DNPC03[5] largely on the basis that it would lead to an improvement in the predictability of charges that would facilitate competition between shippers and suppliers. In making our decision we acknowledged the validity of the argument that only a small proportion of network costs were related to throughput but noted that, apart from network rates, 50 per cent of costs being recovered via the commodity charge were not clearly more related to capacity. Consequently in our decision we stated that the proposal could not be fully justified on the basis of cost reflectivity.

Since DNPC03 was approved, the basis for setting price control shrinkage targets changed as part of the Final Proposals for the current Gas Distribution Price Control Review (GDPCR).[6] The baselines for the current price control period were set as a fixed volume that does not vary with throughput.[7] This change reflects the fact that levels of shrinkage from GDN networks depend more on network characteristics, such as surface area and type of pipe, and very little on gas throughout. The GDNs' current shrinkage baselines are fixed values based on a calculation of expected leakage derived from their networks' characteristics and a standard uplift of 0.031 per cent to cover the costs of own-use gas and theft.

The modification proposal

In light of the implementation of the last GDPCR Final Proposals with the consequent changes to the setting of shrinkage baselines the GDNs have brought forward modification proposal DNPC07. The proposal intends to change the split between capacity and commodity charges from 95:5 to 100:0 respectively.

The GDNs argue that DNPC07 will improve the cost reflectivity of the transportation charges. In the modification report they state that 'At present around 3.5 per cent of DNs' overall revenue is related to throughput whereas under the proposal this will drop to zero, which will be more reflective of the 0.2 per cent throughput-related cost element' . In their modification report the GDNs re-presented analysis they used to support DNPC03. The analysis showed that GDNs' throughput costs were about 5 per cent and most of this, with the exception of 0.2 per cent for own use gas and odorant, are related to shrinkage. The GDNs noted that since DNPC03 and the last GDPCR were implemented the costs relating to shrinkage are no longer considered to be driven by throughput.

The GDNs do not propose to recover the costs of own use gas and theft through a commodity charge because the charge would be too small to justify.

The modification report also argues that the proposal will better meet the relevant methodology objective[8] that transportation charges reflect developments in the transportation business because it follows on from the change in the approach to setting shrinkage baselines.

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[5] Our decision letter for the modification proposal DNPC03 can be found on our website here: http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=141&refer=NETWORKS/GASDISTR/GASDISTRPOL

[6] Final Proposals were published on 3 December 2007. The current GDPCR was set to last between 2008 and 2013. Further details of the current GDPCR can be found at http://www.ofgem.gov.uk/Networks/GasDistr/GDPCR7-13/Pages/GDPCR7-13.aspx

[7] Expected leakage is determined by running an agreed technical model, populated with GDN specific asset data.

[8] As set out in the Standard Special Condition A5(5) of the GDNs' licences, see: http://epr.ofgem.gov.uk/document_fetch.php?documentid=14192

The Authority's decision

In coming to a decision the Authority has evaluated the proposal against the relevant objectives and our wider statutory duties.[9] The Authority has considered the issues raised by the modification proposal, the GDNs' consultation and the GDNs' final report[10] issued on 29 December 2010. We have also considered views that were raised in response to the GDNs' consultation of DNPC07. We note that the overall intent of the proposal was supported by a majority of shippers that responded to the GDNs' consultation.[11] The Authority has concluded that:

1. DNPC07 should not be implemented; and
2. implementation of DNPC07 will not better facilitate the achievement of the relevant objectives.

Reasons for the Authority's decision

Relevant objective (a) - save in so far as paragraphs (aa) or (d) apply, that compliance with the charging methodology results in charges which reflect the costs incurred by the licensee in its transportation business;

DNPC07 is intended to improve the cost reflectivity of the GDNs transportation charging methodology by changing the split of costs recovered through capacity and commodity charges from 95:5 to 100:0. The GDNs consider that their proposal will better achieve relevant objective (a) because, following the change in approach to setting shrinkage baselines, it reflects the fact that only 0.2% of GDN cost are caused by throughput. However, we consider that a compelling case has not been made to justify the proposed change to the GDNs' charging methodology and therefore cannot conclude that the proposal will be facilitate the achievement of objective (a).

We do not consider that the proposal will improve the cost reflectivity of charges because whilst the analysis presented to support DNPC07 suggests that the relationship between throughput and costs has weakened, neither it, nor the supporting arguments, establish a clear link between shrinkage costs and capacity. We raised similar concerns (noted above) in our DNPC03 decision letter and, given the analysis and arguments presented in DNPC07 are largely a repackaging of that presented in DNPC03 rather than how their costs are driven by capacity, commodity or other factors.

Instead of providing an up to date detailed quantitative justification, the GDNs re-presented analysis used over three years ago as part of DNPC03 and relied on the Authority's views as presented in GDPCR Final Proposals to justify their proposal. We consider that a more thorough level of analysis was necessary. We cannot conclude that this proposal will better achieve relevant objective (a) based on the arguments as presented by DNPC07.

Relevant objective (b) - that, so far as is consistent with sub-paragraph (a), the charging methodology properly takes account of developments in the transportation business;

Whilst we acknowledge there has been some change in the regulatory framework since DNPC03, we do not consider that a clear argument has been made for a change in the cause of shrinkage related costs as opposed to shrinkage related revenue or, as we note

[9] The Authority's statutory duties are wider than matters that the Panel must take into consideration and are detailed mainly in the Gas Act 1986 (as amended) as well as obligations arising under EU legislation.
[10] All documents can be accessed via the DCUSA website: http://www.dcusa.co.uk/Extranet/CP.aspx?id=93
[11] Gaz de France SUEZ Energy UK, EON UK, British Gas and SSE supported the proposal, whereas nPower, ScottishPower and EDF Energy did not support the proposal.

above, that the cause of shrinkage related costs is more closely related to capacity. We therefore find it difficult to conclude that the modification proposal is an effective response to development in the GDNs' transportation businesses.

Decision notice

We have decided to reject DNPC07 on the basis that it will not better achieve the relevant methodology objectives set out in standard special condition A5(5) of the GDNs' licences.

In accordance with standard special licence condition A5 of the GDNs' licences the Authority hereby directs that modification proposal DNPC07: 'LDZ System Charges Capacity Commodity Split' is not made.

Rachel Fletcher
Director, Distribution

Signed on behalf of the Authority and authorised for that purpose