# Modification Report
# Revision to the Notice Period regarding the implementation of changes to Transportation Charges
# Modification Reference Number 0073

Version 2.0

This Modification Report is made pursuant to Rule 8.9 of the Modification Rules and follows the format required under Rule 9.6.

## 1. The Modification Proposal

The Proposal was as follows:

"The UNC TPD sets down a Notice Period for informing Users of changes to charges pursuant to Standard Special Condition A4(2) of the Transporter's Licence. The Notice Periods contained within the Licence for informing the Authority and the Notice Periods contained within the UNC for informing Users are distinct, but not inconsistent;

- o minimum one months notice to be provided to the Authority where the licensee has decided to implement any proposals to change the charges or reserve prices; and
- o minimum two months to be provided to Users before the date on which its proposals…are to be implemented

Transportation prices contribute to the total supply costs incurred by suppliers in the business activity of providing gas to customers. These costs are defined by mechanisms outside of suppliers' control, and suppliers seek the recovery of these costs through the charges applied to customers. The current notification methodology carries with it pricing disadvantages.

i. In the most competitive parts of the market the late notification of charges may result in unreasonable losses for suppliers as pass through contracts are both costly to enact and unpopular with customers. Such suppliers have to price keenly based on the information they have at the time and quotations may be necessary well in advance of the contract start date. With the increase in market volatility, customers are negotiating and tendering over a longer and more flexible period than the present two month notice period implies.

ii. Some suppliers may have customers who rarely change their supplier. In these cases the supplier can take a risk on raising prices to cover any possible increases in transportation charges. In such cases the customer ends up paying too much for the monopoly services the supplier is receiving and the supplier achieves extra margin via the recharging process.

In both scenarios transportation charges for monopoly services are adding a risk to the market that the customer will ultimately carry. In addition, there is the risk that the benefits of any charge decreases will not be passed on to those customers who have concluded negotiations well in advance of the contract start date.

Inaccurate transportation charges impact the structure of the competitive market and can distort the final prices paid by customers to the detriment of the market as a whole. An extension to the final notice period would ensure that suppliers have ample time to price contracts effectively, and therefore risk is diminished to the supplier community, and by extension to the customer.

The publication of indicative charges has historically aimed to helped suppliers correctly price contracts. However, recently the indicative charges have been significantly different from the final charges and are therefore not proving helpful.

The accuracy of published transportation charges at the time of customer quotations will become increasingly important as DN prices become more disparate over time. Suppliers should be able to price contracts correctly by region, not simply smear the charges between all customers removing the element of cost reflectivity that Ofgem has been keen to maintain.

The proposal is that the current lead time for the notification of price changes should be extended from 2 months to 4 months.

The Proposer recognises that the timing of implementation of this Proposal may have an interaction with the ability of Transporters to amend the level of Transportation charges. In the event that implementation is delayed because immediate implementation would prohibit the establishment of the required four month notice period in the initial Gas Year, then the Proposer would suggest that, should Ofgem direct implementation, as much notice as practical, rather than the two months minimum specified in the UNC, should be given of any changes to the level of transportation charges prior to formal implementation of the Modification Proposal."

## 2. Extent to which implementation of the proposed modification would better facilitate the relevant objectives

The Proposer put forward the following arguments:

"Increasing notice periods for price charge changes would better facilitate the achievement of the relevant objective:

A11.1 (d) The securing of efficient competition between relevant shippers, suppliers and DN operators.

All suppliers would be able to accurately factor into supply contracts the impact of transportation charge changes. Currently, competition is frustrated in the supply market as the effect of transportation charge changes cannot be accurately calculated for **all** supply contracts."

Workstream discussion developed the following range of views:

"Competition may be frustrated in the supply market as the effect of transportation charge changes cannot be accurately calculated for all supply contracts. Under the terms of their Licences, Transporters are only entitled to change transportation charges once each year, effective from 1 October (NTS charges can also be changed with effect from 1 April each year). This is consistent with the start of the Gas Year, and many supply contracts run from 1 October. Increasing notice periods for transportation charge changes would facilitate suppliers being able to accurately factor into supply contracts the impact of transportation charge changes, especially in the case of contracts which are effective from 1 October in any year. Implementation would therefore facilitate the achievement of relevant objective A11.1 (d), the securing of effective competition between relevant Shippers and Suppliers.

Increasing notice periods for transportation charge changes would reduce the information available to Transporters at the time when changes to charges were determined. This would create uncertainty and be expected to lead to the setting of transportation charges which were less reflective of both costs and the maximum level of allowed revenue which Transporters are permitted to recover.

Reducing the cost reflectivity of transportation charges could lead to inappropriate cost targeting between market segments, and hence may be considered to be inconsistent with facilitating the securing of effective competition.

The increased probability of charges being set at a level which may not reflect the maximum allowed revenue might be expected to lead to increased levels of either under- or over-recovery in any given year. Increasing the probability of over-recovery would be inconsistent with facilitating compliance with Licence obligations since Transporters are obliged to endeavour not to over-recover. To the extent that over-or under-recovery was increased were this Proposal to be implemented, subsequent adjustments to charges would need to be larger - in order to offset the increased over- or under-recovery. This would be expected to increase price volatility from year to year, and hence potentially increase risk in the market, which would not be expected to facilitate the securing of effective competition.

To assess the potential impact on achievement of the relevant objectives were the Proposal to be implemented, Ofgem has indicated that specific information with respect to three areas would be useful:

- The actual timing of suppliers contract negotiations with consumers (when they start and how long they last); *Workstream attendees suggested that this is contract specific and varies according to the circumstances involved. Typically, a minimum of three months is involved for the negotiation process. The time involved is longest for public sector and the very largest customers. While contract start dates are varied, October remains the most common contract start month*.
- how long it takes for suppliers to reflect changes to charges in new bills; *Workstream attendees suggested that two months notice of changes to charges is sufficient time to facilitate accurate billing in the case of contracts with a pass-through arrangement for transportation charges. For other contracts, the change can only be reflected in bills following the renewal date, but can be reflected in offered prices almost immediately*.
- for DNs, the timing of information available on actual revenue and how long it takes to reflect this in final charges. *National Grid Distribution suggested that if transportation charges had to be finalised by 1 June, a key element of demand forecasts, NDM demand forecasts, would not be available. In addition, outturn revenue, and hence the level of carried forward over- or under-recovery from the previous financial year would not be confirmed by 1 June. Other DNs suggested that while they had no experience on which to draw, their processes had been built around the existing timetable and would need to be reconsidered if the Proposal were to be implemented. As an additional issue, National Grid NTS pointed out that using earlier information to set the SO Commodity Charge would be expected to lead to inaccuracy given the factors which influence allowed revenues, with gas prices being the biggest element.'*

TGP responded to the Ofgem requests for specific details on contracting with customers as follows: "*There is still a significant 'bunching' of contract renewals around the start of the Gas Year. There has been a tendency to move toward 'ever-green' contracts however, with a 3 or 6 month termination clause. An increase to a 4 month notification period would therefore provide certainty on prices to customers with 3 month notice periods who wish to switch prior to the start of the gas year*."

Regarding furtherance of the relevant objective:

A11.1 (d) The securing of efficient competition between relevant shippers, suppliers and DN operators.

GDF and TGP echoed the views put forward by the Proposer whereas NGNTS, NGUKD, SGN, STUK asserted implementation would be detrimental.

GDF argued *"Reducing the need for end of contract transportation reconciliation should better facilitate the relevant objective"* and TGP commented, *"As the increase in the notice period will not have a significant impact on the accuracy of the current Transportation Charging process, … the price certainty will facilitate competition between Suppliers."*

NGNTS provided a counter argument. *"Due to National Grid NTS' licence obligation to set prices to recover allowable revenue, implementation would be expected to lead to an increase in price volatility and uncertainty thus frustrating competition in the gas supply market. Additionally, the reduction in cost-reflectivity of transportation charges could lead to inappropriate cost-targeting between market segments, and hence may be considered to be inconsistent with facilitating effective competition."* Similarly NGUKD stated implementation *"would create instability into the charging regime, exacerbating the problems highlighted by Suppliers"*. SGN stated a belief that, *"increased uncertainty and volatility could damage rather than promote competition and result in further risk for shippers and customers."* STUK expressed a view that *" reducing the time allowed for transporters to formulate the charges, reduces the availability and accuracy of the data used and increases the reliance on forecast and estimates."*

Representations from NGNTS, NGUKD and WWU asserted that implementation would be to the detriment of the relevant objective:

A11.1 (c) The efficient discharge of the licensee's obligations

NGNTS argued "*Implementation of this proposal would impact on cost reflectivity in transportation charges as setting charges earlier would lead to the use of less accurate demand forecasting data. Furthermore, Standard Special Condition C8B (1) of the Licence states that transportation owner activity revenue shall not exceed the maximum allowed revenue. Earlier charge setting would increase the risk of potential breach of this licence objective."* Similarly NGUKD considered implementation would impact this relevant objective since it *"would create instability into the charging regime, exacerbating the problems highlighted by Suppliers."*

Corona also suggested, in regard to the timing of variables needed by transporters to generate prices, it would be in keeping with their relevant objectives *"that current practices should be reviewed and modified, including the timing of data collection, to best serve the interests of customers and shippers/suppliers."*

**3. The implications of implementing the Modification Proposal on security of supply, operation of the Total System and industry fragmentation**

No significant impact on security of supply, operation of the Total System, nor industry fragmentation, would be anticipated were the Modification Proposal to be implemented.

**4. The implications for Transporters and each Transporter of implementing the Modification Proposal, including**

**a) implications for operation of the System:**

Implementation of the Modification Proposal would not be expected to significantly impact operation of the System.

**b) development and capital cost and operating cost implications:**

No such implications have been identified.

**c) extent to which it is appropriate to recover the costs, and proposal for the most appropriate way to recover the costs:**

No such cost recovery has been proposed.

**d) analysis of the consequences (if any) this proposal would have on price regulation:**

While associated notice periods would be modified as a result of implementing the Modification Proposal, no consequences on price regulation would be anticipated unless Ofgem or the Transporters were to propose Licence changes which reflected the modified UNC. However, National Grid has indicated that in order to comply with Licence obligations, implementation of the Modification Proposal could lead to them seeking to amend the level of transportation charges more frequently than otherwise. While the licence contains an obligation not to amend transportation charges other than with effect from 1 October (plus 1 April for NTS charges only), this is a reasonable endeavours obligation. By contrast, the Licence obligation to not recover more than the maximum allowed revenue is stronger and it could be argued that failure to reduce transportation charges if even a small over-recovery was projected could be regarded as a Licence breach.

**5. The consequence of implementing the Modification Proposal on the level of contractual risk of each Transporter under the Code as modified by the Modification Proposal**

No such consequences have been identified.

**6. The high level indication of the areas of the UK Link System likely to be affected, together with the development implications and other implications for the UK Link Systems and related computer systems of each Transporter and Users**

No such consequences have been identified.

**7. The implications of implementing the Modification Proposal for Users, including administrative and operational costs and level of contractual risk**

An extension to the final notice period would ensure that suppliers have ample time to price contracts effectively. Therefore risk would be diminished for Shippers and, by extension, customers.

**8. The implications of implementing the Modification Proposal for Terminal Operators, Consumers, Connected System Operators, Suppliers, producers and, any Non Code Party**

By increasing certainty regarding the level of transportation charges, the risk faced by Suppliers may be reduced. Consequently they may be able to offer lower prices to consumers than would otherwise be the case.

**9. Consequences on the legislative and regulatory obligations and contractual relationships of each Transporter and each User and Non Code Party of implementing the Modification Proposal**

No such consequences have been identified.

**10. Analysis of any advantages or disadvantages of implementation of the Modification Proposal**

**Advantages**

- Suppliers would be able to more accurately factor into supply contracts the impact of transportation charge changes.

**Disadvantages**

- The Transporters would need to reschedule the processes for determining price changes
- The information underpinning the setting of transportation charges would be more out of date, which increases the potential volatility of charge levels year on year.
- The level of transportation charges may be adjusted more frequently than otherwise.

**11. Summary of representations received (to the extent that the import of those representations are not reflected elsewhere in the Modification Report)**

Representations were received from the following parties.

| | | |
|---|---|---|
| Corona Energy | (Corona) | Support |
| EON UK | (EON) | Qualified Support |
| Gaz de France ESS UK | (GDF) | Support |
| National Grid NTS | (NGNTS) | Against |
| National Grid UKD | (NGUKD) | Against |
| Northern Gas Networks | (NGN) | Against |
| RWE Npower plc | (RWE) | Against |
| Scotia Gas Networks | (SGN) | Against |
| Scottish and Southern Energy plc | (SSE) | Against |
| Statoil (UK) Gas Limited | (STUK) | Against |
| Total Gas & Power Limited | (TGP) | Support |
| Wales and West Utilities | (WWU) | Against |

Three parties expressed support (Corona, GDF, TGP), one qualified support (EON), and eight were against implementation of the Proposal (NGNTS, NGUKD, NGN, RWE, SGN, SSE, STUK, WWU).

Consumer contracts

Further to the aspiration for all suppliers to be able to accurately factor into supply contracts the impact of transportation charge changes, in its representation Corona stated "*It is known that a significant portion of the I&C market operates in accordance with the Gas Year, striking contracts with a start date of October 1st. Typically, the customer led processes of selection and negotiation are in excess of two months prior to the strike date. At present, this means the transportation element of the overall supply cost will not reflect the actual costs prevailing at the time the contract is in operation. In the event that customers are willing to accept "transportation cost pass through" price changes can be introduced prior to or during the contract year. Unsurprisingly, "cost pass throughs" are not popular among many customers and Corona would argue that they should not be necessary, in any case. It does not reflect well on the gas market that previously agreed prices should be subject to change due to third party charge variations.*

*In the event that "cost pass throughs" are not permitted by customers, then there maybe a number of consequences;*

- *Customers will not realise the benefits of lower than forecast transportation costs;*
- *Suppliers are unreasonably exposed to additional costs in a highly competitive, low margin market;*
- *In some cases, it maybe that suppliers place a premium on contract offers to mitigate against price risk (this assumes limited competition for the contract, which may be the result of overall price risk)*
- *Smaller suppliers, particularly those with a geographical bias will face disproportionate price risk."*

EON argued that "*It is important for all suppliers to be able to price customers correctly and extending the lead time for the notification of price changes from two to four months enables suppliers to adjust the customer price to reflect the charges actual levied. Moreover, extending the lead time will also reduce the risk premium suppliers currently may need to build into the customer's price."*

GDF set the scene regarding energy purchasing behaviour and supplier response and stated, "*The increased flexibility offered to customers has meant there is now a wider time-band available in which to contract than was previously the case. Generally as products become more complex additional lead-time is required for negotiations and so the call for a four month notification of transportation charges is now timely."*

GDF went on to another perspective of October contract renewal. *"A significant proportion of Industrial and Commercial gas contracts renew in October and fixing the rate gives significantly less requirement for suppliers to reconcile transportation costs throughout or at the end of the contract for customers who pay transportation charges on a pass through basis. Reducing the need for end of contract transportation reconciliation should better facilitate the relevant objective A11.1d, the securing of effective competition between relevant shippers, suppliers and DN operators."* and then asserted "*Customer charges should be more accurate in the first instance therefore reducing the need for financial reconciliation, which may slow down or even deter customers from switching supplier.*

*Also, implementation of this modification may lead to a reduced administrative burden and cost savings for suppliers, which should result in better competition in supply where customers can benefit from lower prices.*

*Significant swings in transportation charges (indicative to actual) as seen recently increase the materiality of, and therefore the need for reconciliation. Previously, smaller changes may have been deemed uneconomical to recover by suppliers."*

TGP commented, *"Transportation Charges presently reflect a balance between using the most accurate demand forecast data available, against giving sufficient time to shippers to correctly price contracts"* and TGP *"did not believe a movement of the deadline for publishing final Charges will significantly reduce their accuracy"* and therefore *"the price certainty will facilitate competition between Suppliers."*

NGNTS observed that "*Although recognising the perceived benefits that the Proposer has suggested would arise from implementation, National Grid NTS believes that this would only provide certainty in charges in the short term and thus would benefit only those shippers who set supply contracts with consumers at short notice (e.g 2-3 months) and on a frequent basis. However, we believe that this would be outweighed by the detrimental effects on gas supply contracts due to the increased volatility and lack of certainty in transportation prices that would arise in the medium to longer term*." RWE and SSE made similar observations.

NGUKD acknowledged; *"any variability in prices may cause Suppliers difficulties, the proposed modification is likely to introduce more inaccurate charges and amplify the fluctuations between years.*

*Customers who seek to actively partake in the market to ensure that they secure the best deal, require a market where direct comparisons can be made between contracts, between Shippers, and between periods. Whilst established charges for the first year may help Suppliers set prices in the first year, the subsequent volatility would make the ongoing comparability of prices much more difficult, which is detrimental to an efficient market…*

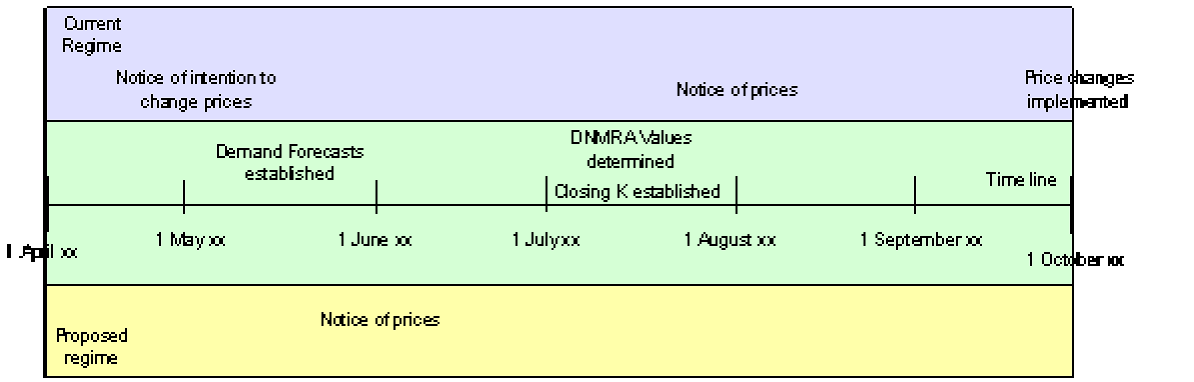
*…Customers who do not actively partake in the market would also suffer where prices fluctuate more significantly. Within its Modification Proposal, the proposer acknowledges that any increase in transportation charges would be passed on to the customer. Whilst this is appropriate when the Supplier's costs are increasing, it is possible that a Supplier would not pass on benefit when the transportation charges fall, when the Supplier has a customer who does not actively consider alternative Suppliers. As a result, any increase in the magnitude in the change to transportation charges, as we predict under the modification, would be likely to be detrimental to the customer and the efficiency of the supply market."*

NGUKD put forward a suggestion that could *"give both the Supplier and the customer ample time and full visibility of the transportation charges during the contract negotiation period. …… By extending current contracts so that new contracts do not start until the charges have been finalised, Suppliers would allow the current pricing schedule to be maintained, with the benefits of accurate prices that that brings while also eliminating the issues that the Suppliers are experiencing. Delaying the start of a new contract would give the Supplier full visibility of the transportation charges for 11 months of a 12 month contract."*

NGN, in a similar vein, stated, *"One of the factors behind this Modification proposal is the existing practice of customer contracts being aligned to the October gas year period. Should the existing two month period be retained, then suppliers may be able to improve individual competitive advantages by altering the start date of such contracts to fully reflect the actual prices currently provided two months ahead of this October date."*

<u>Information for setting of transportation prices</u>

NGUKD provided a DN timeline:




NGUKD argued: *"Bringing the setting of charges forward, in line with the proposal would require prices to be set without a full picture of the over or under recovery."* In particular price setting should use *"an up to date forecast of the Mains Replacement Incentive position for the following year (DNMRA)."* Also *"The volume data is critical in establishing the forecast allowed revenue and forecast collected revenue for the following period."*

Similarly, SGN stated: *"Currently forecasts of transportation volumes for the networks are produced in the middle of May each year. This is the earliest point at which we believe forecasts can be produced, taking into account actual performance over the whole of the previous formula year, particularly the crucial winter period. If we were required to give firm notice of changes in charges on 1 June it would not be possible to make use of these forecasts. This would mean that the proposed changes in charges would be less accurate in terms of making the appropriate adjustments, equating collected revenue and allowed revenue i.e. under or over recovery."* SGN highlighted that *"new volume forecasts can be significantly different"*. On Mains Replacement data and more generally SGN stated *"actual activity and costs over the entire formula year is not available until some time after the end of the formula year. Figures have to be submitted to Ofgem by the end of July, this is just in time to be taken into account when setting final charges to be published on 1 August. Final figures can vary from earlier estimates and can have an impact on price changes. If the notice period becomes four months instead of two, it will not be possible to take the final figures into account, creating another source of uncertainty which would have to be corrected in future pricing periods."*

In respect of information for price calculation if the modification were implemented, SSE recognised that *"forecasts would need to be used rather than actual data"* and similarly STUK *"a lot of the data used would be based on forecasts and estimates."*

NGNTS provided examples about the effect on sources of information available for price calculation if the proposal were implemented. *"Around 50% of the SO commodity charge seeks to recover shrinkage costs in the NTS, which is heavily dependant on gas costs and thus difficult to forecast accurately."* Similarly, NGNTS pointed out that *"the setting of appropriate TO exit capacity charges requires access to the most up to date demand forecast information. This is agreed annually as part of the Industry wide TBE ("Transporting Britain's Energy") consultation process, and permits the demand supply statements to be completed in May. A notice period of four months, requiring final charges to be announced by 1 June, would not allow sufficient time to utilise the information obtained from the outcome of the demand forecasting cycle when calculating the new charges, thus necessitating the use of the previous year's demand forecasts."* NGNTS echoed the comments of SGN regarding finalisation of the outturn from the previous formula year.

STUK advocated, "*transportation rates* [should be] *determined using the most accurate information available."*

WWU echoed the comments regarding the availability of data from the Transporting Britain's Energy consultation and the comments on Main Replacement data.

Corona stated it *"does have some sympathy with the transporters' position that certain variables needed to generate prices are not known until later in the year. We would suggest, however, that current practices should be reviewed and modified, including the timing of data collection, to best serve the interests of customers and shippers/suppliers."*

GDF stated: *"Should this modification be implemented there would clearly be a need for a common methodology across DN owners for setting charges within a forecast range. Charges could be set at mid-point of the forecast range or at the level of the most likely scenario but disregarding unlikely or extreme options."*

<u>Volatility in Transportation Charges and Frequency of change</u>

The Corona representation, in expressing its concern about the potential detrimental effect on shippers/supplies, stated: *"This point is highlighted by examining the forecast price changes compared to the actual price changes as experienced during 2005. For information a table displaying the significant variances is provided in the Appendix to this* representation."

Corona also stated: *"On the basis that transporters are able to reschedule certain activities, this should limit the likelihood of within year changes being made to address any revenue excursions."*

GDF commented *"Given the best endeavours obligation for transporters to set charges accurately there is a concern that transporters may choose to reset charges within any gas year if initial forecasts prove wrong. Many of the benefits for customers and efficiencies for suppliers would be undone if this were the case therefore re-setting charges should be avoided wherever possible. Divergence of charges across regions has been driven by the need for cost reflectivity and is likely to be an enduring feature going forwards, this may add to volatility.* " and GDF went on to observe that, "*Appropriate incentives already exist for transporters, which encourage forecast accuracy. These should discourage overly cautious initial charge submissions, which could lead to price revisions mid-term."* GDF also asserted "*Should this modification be implemented there may be reduced volatility as a level of smoothing is experienced year on year.*"

EON commented: "*As part of the sale of National Grid's Distribution Networks, E.ON UK stressed the importance of maintaining certainty and stability wherever possible. We are concerned that implementation of this proposal would run the risk of counteracting the stability of changes to charges only once / twice per year, dependent on whether they are transmission or distribution charges. Given that the transporters have a best endeavours licence obligation not to over-recover, we are concerned that the level of transportation charges may be adjusted more frequently than otherwise, to account for a potential increase in volatility. We would want confidence that stability in charges would not be compromised before we could offer our full support for this proposal.*"

NGN asserted that implementation would "*in effect mean the Transporters indicative prices would become its actuals going forward. The likely consequences of such a change would be a marked swing in year on year transportation charges as each Transporter 'corrected' its actual prices with more robust data for each subsequent years price changes.*"

NGNTS asserted that *"Increasing the notice period to four months, as contemplated by the Proposal, .. would bring about a number of consequences that could be seen as counter – productive to charge stability"* . NGNTS also commented that *"The variation between one year's forecast demand figures and the next, for a typical year, can be up to 2%, and therefore this approach could have an adverse impact on the level of 'K', and would hamper National Grid NTS' ability to set charges using the most accurate cost-information."* NGNTS's view was that implementation "*would lead to consequential impacts in the following areas:*

- *Greater forecasting uncertainty – due to reduced information being available at the time that charges are set*
- *Price volatility – since increased forecasting errors would generate greater levels of 'K', leading to larger subsequent corrections in charges*
- *Frequency of price changes – as a result of greater volatility in charges, it is more likely that we would need to change charges twice per year*
- *Price certainty – at the four month notice period, the confidence in the appropriateness of the published final prices would not be significantly greater than that for the 150 day (5 month) indicative notice."*

Similarly, NGUKD stated that due to incomplete information, "*the subsequent price changes which are required in the following periods are likely to be larger because the DNK values carried forward from the previous year would be greater. This volatility would continue into future periods as each inaccurate charge setting would require a large change to correct for the previous over or under recovery. Such fluctuations would not serve the market efficiently because the greater variability would hinder the customers' ability to effectively compare prices.*

*A potential impact of this volatility could be the Transporter being duty bound by Licence obligations to amend prices more than once a year to ensure that there was not significant* *over recovery. This would further exacerbate the issues that Suppliers are facing by further reducing the predictability of charges.*

*Whilst National Grid acknowledges any variability in prices may cause Suppliers difficulties, the proposed modification is likely to introduce more inaccurate charges and amplify the fluctuations between years*."

RWE illustrated its view on volatility as follows: *"Last summer the changes proposed at the 150 day point were significantly different to the final outcome, and we believe that the industry was surprised by the extent of the difference. If the October prices had been based on the indicative view in April it is likely that there would have been a significant amount of over and/or under recovery across the networks by the time the next price change was due. Such volatility is likely to increase the further out in time that the price change is determined. We believe that customers would prefer to have a series of more certain price changes than wildly fluctuating charges from year to year. The proposal to change the notice period of changes from 2 months to 4 months would in our opinion increase the likelihood of larger than necessary over or under recovery.*

*The current debate about the cost reflectivity of the Commodity and Capacity charges has highlighted the fact that a move to increase the percentage of the Capacity charge will reduce the uncertainty about recovered revenue. As this debate has not yet reached a conclusion it seems inappropriate to introduce a change to the current arrangements at this time."*

SGN observed that: "*Whilst proposed changes may provide more time to price contracts, SGN believes the reduced accuracy of the price changes could be detrimental and could result in greater levels of under and over-recovery at the end of each formula year. Further consideration may need to be given to the requirement to only change charges on 1 October if changes to notice periods resulted in larger percentage changes in charges from year to year. Larger changes in charges can lead to a "see-saw" effect, where a large increase one year to recover an under-recovery has to be followed by an equally large reduction the following year to avoid over-recovery. SGN believes that this increased uncertainty and volatility could damage rather than promote competition and result in further risk for shippers and customers.*"

SSE also observed there was, *"the potential to create large year on year changes, leading to lack of stability and volatility. In extreme cases a licence condition not to over recover may cause multiple changes to charges within year."*

STUK commented that the effect of incomplete data at the time of price notification *"could lead to high level of price uncertainty as volatility in changes to charging levels year on year would be expected and could lead to over or under recovery."*

WWU in a similar vein to other transporters stated: *"Under the DN Licence, WWU is required to use reasonable endeavours to only change charges once per year. However if charges were to be published by 1 June, the basis of their calculation would have more built in inaccuracy. DNs also have an obligation to endeavour not to over-recover which is a stronger Licence obligation and therefore could lead to DNs proposing additional charging changes to prevent a Licence breach if an over-recovery was projected."*

Accuracy and variability of Transportation Prices

Corona stated: *"The DNs operate under individual price controls, which in time, will develop to reflect specific costs and investments, operational efficiencies and potential directed incentive schemes. This is likely to produce greater variability in distribution related transportation charges, irrespective of the development of new charging methodologies which may be introduced independently by the DNs. By the very fact that DNs will be targeting revenue recovery over limited services and are unable to offset revenue growth in one discrete area against revenue restriction in another, means that, in total national transportation prices, are likely to become more variable. We suggest that the potential for greater locational price variability, or indeed less accurate price forecasts as currently provided, are likely to affect smaller shipper/suppliers with more concentrated customer portfolios i.e. those will limited geographic dispersal.*

*We would also add that, the forecasting capability of the individual DNs is uncertain and it is highly probable that some will perform better than others. Again, this has the potential to have a detrimental affect on shipper/suppliers."*

EON however noted that: "*the proposal also runs the risk of inaccurate transportation charges as transporters may have less information available to them when setting the charge, leading to a loss of cost reflectivity and uncertainty with respect to the level of allowed revenue, which Transporters are permitted to recover."*

NGN argued that pricing accuracy would decrease. "*Should Transporters be compelled to provide price changes some four months ahead of the current October price change, there is an increased likelihood that Transporters will over recover and as a consequence be penalised under the various Licence conditions which govern such over recovery scenarios. No Transporter will readily risk such an over recovery and as such the prices utilised may understate the likely change to better protect any chance of over recovery. Clearly such a move would serve to exacerbate the imposed decrease in pricing accuracy this modification proposal brings."*

NGNTS provided a specific example of the potential effect of implementation. *"Had a four month notice period been in place, then the SO commodity charge set from October to March 2006 would have been around 20% below the level that would otherwise have been the case."*

NGUKD stated: *"The effect of incomplete information is demonstrated when looking at the indicative charges for 2005/6 which were established with equivalent data to that that would be available if the proposed modification were adopted. If National Grid had applied the indicative charges, the latest DNK values for March 2006 would have been materially larger for all of the networks, with DNK for London exceeding 4% of allowed revenue (over-recovery). This is clearly inconsistent with licence requirements that charges should be cost reflective and that the Transporter should not aim to over recover in a period, since National Grid knew by July that the indicative charges would over-recover."*

On the topic of individual DN price controls and potential price variability NGUKD commented: "*Bringing the setting of prices forward would not directly impact upon the divergence of prices between networks."*

RWE made an observation regarding the significance of transportation prices to consumers. *"This winter we have experienced unprecedented changes in the cost of gas, which dwarf any changes between predicted and actual changes to transportation charges. This has caused many problems to Suppliers as evidenced by the number of small participants exiting the market this winter."*

SGN explained the potential impact of the proposal on accuracy of price change and some specific points are referred to in the above section on Information for setting of Transportation Charges and elsewhere in this report.

SSE noted, *"the potential to generate charges that are not cost reflective"*.

**12. The extent to which the implementation is required to enable each Transporter to facilitate compliance with safety or other legislation**

No such requirement has been identified.

**13. The extent to which the implementation is required having regard to any proposed change in the methodology established under paragraph 5 of Condition A4 or the statement furnished by each Transporter under paragraph 1 of Condition 4 of the Transporter's Licence**

Implementation is not required having regard to any proposed change in the methodology established under paragraph 5 of Condition A4 or the statement furnished by each Transporter under paragraph 1 of Condition 4 of the Transporter's Licence**.**

**14. Programme for works required as a consequence of implementing the Modification Proposal**

No programme of works has been identified, other than rescheduling the pricing notification timescales.

**15. Proposed implementation timetable (including timetable for any necessary information systems changes)**

Following discussion at the Workstream meetings concerning the possible need for transitional arrangements should the Modification Proposal be implemented within four months of a potential change to the level of transportation charges, the Proposer amended the Proposal to include a view that, should implementation be delayed until after a price change was made, the Transporters should nonetheless provide as much notice as practical of any proposed change.

NGN stated "*for this year (2006), any implementation would need to take account of the internal governance of Transporters which would require a minimum of 4-6 weeks to get any actual price changes signed off at the appropriate level, should the existing two month window alter in any way."*

**16. Implications of implementing this Modification Proposal upon existing Code Standards of Service**

No such implications have been identified.

## 17. Recommendation regarding implementation of this Modification Proposal and the number of votes of the Modification Panel

At the Modification Panel Meeting held on 16 March 2006, of the 10 Voting Members present, capable of casting 10 votes, 3 votes were cast in favour of implementing this Modification Proposal. Therefore the Panel do not recommend implementation of this Proposal.

## 18. Transporter's Proposal

This Modification Report contains the Transporter's proposal not to modify the Code and the Transporter now seeks agreement from the Gas & Electricity Markets Authority in accordance with this report.

## 19. Text

The proposer has not provided draft text.

Subject Matter Expert sign off:

*I confirm that I have prepared this modification report in accordance with the Modification Rules*.

Signature:

Date :

Signed for and on behalf of Relevant Gas Transporters:

**Tim Davis**
**Chief Executive, Joint Office of Gas Transporters**

Signature:

Date :