

Modification proposal:	Uniform Network Code (UNC) 0186/0186A: Provision of cost information (UNC0186/186A)		
Decision:	The Authority ¹ directs that proposal UNC0186 be made ²		
Target audience:	The Joint Office, Parties to the UNC and other interested parties		
Date of publication:	1 May 2008	Implementation Date:	To be confirmed by the Joint Office

Background to the modification proposal

Shippers need to be able to forecast their input costs in order to plan various aspects of their business (pricing strategies, cash management, etc.) A key input to these costs is the level of distribution charges. Total distribution charges payable by each shipper will depend on factors including the structure of charges, GDNs' allowed revenue, number of customers and throughput. The GDNs are best placed to make these forecasts and in particular, estimations of allowed revenue, as they will have the best insight into their likely performance under the incentive schemes.

GDPGR 2008-13 introduced a number of new incentives, thus increasing the complexity of allowed revenue calculations. Currently, the UNC does not provide for regular detailed forecasts of charges for several years ahead to be provided to shippers, and there are no comparable information requirements arising from the GDNs' licences that the shippers could utilise.

The modification proposal

The proposal seeks to extend the scope of a previous Modification Proposal (698³) to provide the detailed information shippers require in respect of allowed transportation revenue and expected changes to charges for the reasons set out above. To this end the following information is to be made available by each GDN on a quarterly basis, for the current year and the subsequent 4 years, based on the GDNs' latest best estimates where the exact figure is not known:

- core allowed revenue;
- sum of cost pass-through items;
- sum of all incentive payments and adjustments;
- assumed inflation rate;
- final allowed revenue;
- expected collected revenue;
- over/under-recovery for year, and;
- percentage change to charges required at next charging year.

The UNC will be modified to set out the relevant definitions and assumptions to underlie the forecast, and the GDNs will provide a commentary where necessary to explain the data. It is not the intention of the modification that the information provided by the GDNs will be challenged by the shippers, although reasonable questioning can be expected.

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 38A of the Gas Act 1986.

³ Network Modification 698: [Requirement for Publication of Transco's Billed Charges against Target](#)

As the price control period progresses, the projection will fall beyond the end of the price control period. Clearly the GDNs will not know the basis of the subsequent price control, or the details of the incentives to which they will be subject, in order to make a forecast. On the other hand, the shippers still have a need to incorporate the best forecast that they can. This problem has led to two variants of the proposal.

- a) Modification Proposal 0186 provides that forecasts for the period beyond the extant price control will be based on assumptions as agreed by both the GDNs and shippers, which will take into account any relevant Ofgem publications and latest price control proposals.
- b) Modification Proposal 0186A asserts that it is not possible to forecast beyond the end of the existing price control period. Any projections beyond the existing price control could be misleading and not in keeping with the purpose of the proposal. GDNs will discuss possible outcomes of the next price control period with shippers at the DCMF and once Ofgem has published specific proposals for the following price control period, the GDNs will start publication of forecast information in the agreed format for that price control period.

Aside from these differences, the variants are essentially the same.

The proposer considered that the proposed modification would better facilitate the objective set out in Standard Special Condition A11 of the Gas Transporter licence, paragraph 1. (d) (i), namely to secure effective competition between relevant shippers. Some respondents to the proposal also considered that it better facilitated other objectives, as set out in the reasons for the Authority's decision section below.

UNC Panel⁴ recommendation

At the Modification Panel meeting held on 21 February 2008, 6 votes (out of a possible 10) were cast in favour of implementing proposal 0186. Therefore the Panel recommended implementation of the proposal. At the same meeting, 7 votes were cast in favour of implementing the alternative proposal 0186A. Therefore the Panel recommended implementation of the alternative proposal. The Panel then voted on which of the two proposals could be expected to better facilitate achievement of the Relevant Objectives. 4 votes were cast in favour of implementing proposal 0186 and 4 votes were cast in favour of implementing the alternative proposal 0186A.

The Authority's decision

The Authority has considered the issues raised by the modification proposal and the Final Modification Report (FMR) dated 21 February 2008. The Authority has considered and taken into account the responses to the Joint Office's consultation on the modification proposal which are attached to the FMR⁵. The Authority has concluded that:

1. implementation of the modification proposal 0186 will better facilitate the achievement of the relevant objectives of the UNC⁶; and

⁴ The UNC Panel is established and constituted from time to time pursuant to and in accordance with the UNC Modification Rules

⁵ UNC modification proposals, modification reports and representations can be viewed on the Joint Office of Gas Transporters website at www.gasgovernance.com

⁶ As set out in Standard Special Condition A11(1) of the Gas Transporters Licence, see: http://epr.ofgem.gov.uk/document_fetch.php?documentid=6547

2. directing that the modification be made is consistent with the Authority's principal objective and statutory duties⁷.

Reasons for the Authority's decision

In this letter we first consider whether the provision on a quarterly basis of forecast information pertaining to future allowed revenue and distribution charges better facilitates the achievement of the relevant objectives of the UNC and is consistent with the Authority's principal objective and statutory duties. Following this, we then consider which of the two proposals best facilitates the relevant objectives.

Extent to which implementation of the proposed modification would better facilitate the relevant objectives:

1(a) the efficient and economic operation of the pipe-line system

The proposer was of the view that this objective would be better facilitated by the Proposal, inasmuch as the GDNs have an obligation to establish economic transportation charging arrangements which facilitate the efficient operation of their pipeline system.

One respondent disagreed, since implementation of the Proposal would not provide any additional information to GDNs.

We do not consider that the provision of this information to shippers benefits the *operation* of the pipeline system, since this is information already available to the GDNs themselves and in any case is not operational information.

1(c) the efficient discharge of the licensee's obligations under this licence

The proposer notes that standard condition 9 of the transporter's GT licence has an obligation to establish economic charging arrangements which facilitate the efficient operation of the pipeline system, secure effective competition between relevant shippers and which secure domestic security standards. Since this proposal should help to secure effective competition between shippers, it should also further this relevant objective.

This proposal does not impact the charging arrangements, and therefore we do not support the argument above. We note that standard condition 9 is turned off in the GDN licences and so is not relevant.

1 (d) securing of effective competition between relevant shippers, relevant suppliers and gas transporters

The proposer was of the view that implementation would provide shippers with information that could be used to more accurately forecast changes to transportation charges.

We agree that the provision of forecast information relevant to the calculation of transportation charges should better facilitate competition between relevant shippers and between relevant suppliers. In particular, the additional transparency provided by this information should enable shippers and suppliers to improve the accuracy of their own forecasts and assessments and to feed these forecasts into their own pricing strategies

⁷The Authority's statutory duties are wider than matters which the Panel must take into consideration and are detailed mainly in the Gas Act 1986.

within the market. Shippers and suppliers should be able to make their own use of the information that is made available to compete more effectively in the market. In addition, by making forecasts of future charges more accurate, shippers and suppliers would face less uncertainty with respect to future changes in these charges which should also better facilitate the securing of effective competition between relevant shippers and between relevant suppliers. One of the respondents notes that large consumers may have supply contracts that include a pass-through of transportation charges, and so such consumers may directly benefit from having access to the GDNs' forecasts.

We note the concerns of several respondents that the assumptions required for making forecasts beyond the price control period run the risk of producing misleading forecasts on which users may place undue reliance. However, we consider that the primary users are likely to be shippers and large customers, whose business decisions entail a sophisticated assessment of forecast information on a regular basis and so, providing the assumptions are clearly stated, the risk of undue reliance is very low. As one respondent noted, these parties are often attempting to produce forecasts themselves in any case, and this would simply be an additional source of information for them to use as appropriate.

Both variants of the proposal facilitate this objective better than the current arrangements, because more information is being provided over a longer time horizon, as several respondents noted (from both the shipper and the GDN sides). For the reasons outlined above, we also consider that the proposal is consistent with Ofgem's principal objective to protect the interests of consumers, wherever appropriate by promoting effective competition.

Based on the considerations above, as both proposal 0186 and alternative proposal 0186A entail the regular provision of relevant information on revenues and charges to shippers, they both better facilitate the relevant objectives. We now consider which of the two proposals best facilitates these objectives.

Decision between the two variants of the proposal

As noted above, it is extremely difficult for GDNs to predict their allowed revenue beyond the end of the price control, at least until Ofgem publishes a set of proposals for the new price control period, which typically does not happen until the final year of the previous control. The GDNs do not know exactly how Ofgem will assess the costs needed to run their networks efficiently, nor what incentive mechanisms they will be subject to. Even where they can expect adjustments for events occurring during the existing price control period (for changes in defined benefit pension scheme contributions, for example, or a clawback of any excess interest tax shield) they may not know the exact basis of the calculation or the period over which it is spread.

Nevertheless, there is an underlying principle to price control settlements that they are designed to cover the reasonable costs of an efficiently operated network, including return on capital invested. From time to time GDNs may anticipate a cost shock, whether in the form of above-inflation increases in key input costs or the introduction of a new element of costs (examples include costs arising under new legislation such as the Traffic Management Act, or as a result of the reform of industry arrangements, such as NTS offtake reform). The GDNs can reasonably expect that to the extent these costs are incurred efficiently, that they will be able to recover them in the next price control (whether that will include recovery of costs incurred in the current price control period will depend on a number of factors) and so that they will feed through to distribution

charges. While the quantum of these costs may not always be certain in advance the GDNs' best attempts to forecast them can provide valuable signals to shippers that charges can reasonably be expected to rise. The converse is true of course, that if real price effects are anticipated to be negative, or a category of costs is expected to cease then the GDNs can provide signals that (real) charges may fall.

We consider therefore that the objectives are better facilitated by the variant that provides the shippers with better information. Proposal 0186 provides better information than alternative proposal 0186A, because it includes forecasts beyond the end of the price control period, albeit these are based on a set of highly uncertain assumptions. The recommendations and representations of the shipper members of the Panel demonstrate their requirement to have such information even though they recognise it is of limited use. The GDNs' concerns about the potential for such information to be misleading is noted, and the Authority considers that the assumptions need to be carefully considered and clearly stated so that shippers understand the basis of these forecasts. We understand that the details of the assumptions are likely to be set out in a subsequent modification proposal.

One GDN respondent expressed concern that such forecasts might prejudice Ofgem's price control decision making process. For the avoidance of doubt, the Authority's decisions are made on the basis of all the evidence available to it. In the case of price controls this includes a review of detailed forecasts made by the licensees and consideration of their supporting arguments and other respondents' views. Thus any high level forecast made under a specific set of assumptions for the purposes of the quarterly reports referred to in this proposal will not prejudice the Authority's decisions.

Decision notice

In accordance with Standard Special Condition A11 of the Gas Transporters Licence, the Authority, hereby directs that modification proposal UNC 0186: Provision of Cost Information be made.

Rachel Fletcher,

Director, Distribution

Signed on behalf of the Authority and authorised for that purpose.