Joint Office of Gas Transporters

Stage 01: Proposal

What stage is this document in the process?

01 Proposal
02 Workgroup Report
03 Draft Modification Report
04 Final Modification Report

0368: Smoothing of Distribution Charge Variation

Smoothes variation of Distribution Charges by spreading any under or over-recovery for any particular year over the following four years.

The Proposer recommends
The modification is referred to a Workgroup for Assessment

High Impact:
Shippers, Transporters

Medium Impact:
Customers

Low Impact:
None

Contents

About this document:

This document is a proposal, which will be presented by the Proposer to the Panel on 17 March 2011. The Panel will consider the Proposer's recommendation, and agree whether this modification should be referred to a Workgroup for assessment.

Any questions?

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1 Summary

Is this a Self Governance Modification

This modification will have a material impact on how the Transporters set transportation charges, so is not suitable to be considered under the Self-Governance Process.

Why Change?

At present distribution charges are volatile and unpredictable, exposing shippers and customers to significant annual cost variation. This increases administration and risk costs to the industry.

Solution

Smoothing of any under or over-recovery over a four year period. In addition Distribution Charges may only be altered once a year at the beginning of the financial year.

Impacts & Costs

Smoothing the variability of distribution charges will reduce their volatility, so reducing the risks faced by shippers and consumers with regard to cost variability. To ensure that the DNs are not unduly penalised, there may be benefit in adjusting the Gas Transporter licences to take into account the new process.

There will not be any significant costs incurred from the implementation of this change.

Implementation

We believe that this modification should be implemented from 1 April 2012, whilst acknowledging that an optimum implementation date may be 1 April 2013 so that its implications can be taken into account in the new price control.

The Case for Change

Improving cost predictability will reduce uncertainty in the market, so reducing costs and facilitating competition.

Recommendations

We propose that this modification goes for assessment at a workgroup.

2 Why Change?

The Distribution Network Operators (DNs) are required, under Standard Special Condition A4 of the Gas Transporter licence, to develop and implement a charging methodology for determining charges for using their networks. The Gas Transporter licence also creates a variety of obligations with regard to publishing of changes to charges, including suitable notice periods for any changes.

In addition Special Condition Part E also places obligations on how the DNs collect allowed revenue each year. This part of the licence goes into some detail on how much revenue the DNs are allowed to recover, but in particular Special Condition Part E2B requires that *"The licensee shall use its best endeavours in setting its charges to ensure that in respect of any formula year t the Distribution Network transportation activity revenue for the Distribution Network covered by this condition (DNRt) shall not exceed the maximum Distribution Network transportation activity revenue (DNMRt) in that year."*

The various obligations and incentives placed around the charging regime through the Gas Transporters licence, (in particular the obligation not to over-recover in any one year) have resulted in unpredictable and volatile transportation charges. A primary cause is that the Gas Transporters are effectively required to recover all of their allowed revenue for a particular year in that year, with only a limited ability to roll over any under or over-recovery to the next year.

We have provided analysis back to 2009, when the charging setting process moved to a 95:5 Capacity:Commodity charging basis split.

% changes for SSP load band				% Change between years	
Year	2009-10	2010-11	2011-12	2009/10	2010/11
Northern Gas Networks	**0.1307**	**0.1377**	**0.1465**	**5.36%**	**6.39%**
National Grid Distribution (East England)	**0.1226**	**0.1285**	**0.1386**	**4.81%**	**7.86%**
National Grid Distribution (London)	**0.1405**	**0.1325**	**0.1509**	**-5.69%**	**13.89%**
National Grid Distribution (North West)	**0.1329**	**0.1492**	**0.1544**	**12.26%**	**3.49%**
National Grid Distribution (West Midlands)	**0.1331**	**0.1452**	**0.1541**	**9.09%**	**6.13%**
Scotland Gas Networks	**0.1266**	**0.1382**	**0.1624**	**9.16%**	**17.51%**
Southern Gas Networks	**0.1247**	**0.1334**	**0.1586**	**6.98%**	**18.89%**
Wales & West Utilities	**0.125**	**0.1318**	**0.1517**	**5.44%**	**15.10%**

Note that these comparisons ignore mid-year corrections.

Though a move to a 95:5 Capacity:Commodity charging basis split was expected to reduce the volatility of previous prices movements, as can be seen above this has not been the case. This volatility and unpredictability causes significant issues to shippers and consumers. When offering prices to customers, shippers attempt to build in any potential variation of costs going forward. The volatility of the current pricing structure prevents shippers from adequately undertaking risk mitigation, and they have to estimate changes with little confidence that any projection will be accurate.

When actual charges deviate from the estimated figures that have been used, shippers are forced to either vary their prices within year, with the additional cost and administrative burden that entails, or accept the resulting adjustment to their bottom line.

For customers the negative impacts are twofold. It removes any predictability for their gas costs, exposing them to unfavourable price movements. Also the additional costs faced by shippers in handling this volatility, including any risk premium reflecting this element of uncertainty, ultimately increases costs to all customers.

An obvious solution to these problems is to spread any variability across a longer period.

3 Solution

It is proposed that the DN Transportation Charging Methodology (as in Section Y of the UNC) is modified in order to limit the amount of over-recovery which the DNs take into account when calculating the level at which to set charges in the following year. Specifically, it is proposed that the methodology provides that any under or over-recovery between allowed revenue and that collected by the DNs (termed the Distribution Network Transportation Activity Revenue adjustment or K_t) is used to adjust charges over a [4] year period, rather than being able to be offset in whole in the following year. This will ameliorate any variance year-on-year.

In addition to provide certainty that changes will not vary within year, it is further proposed that charges can only be varied once a year at the start of the financial year. For the avoidance of doubt no mid-year correction would be permitted.

The impact of this proposed solution is most vividly illustrated through scenario modelling.

Current Process

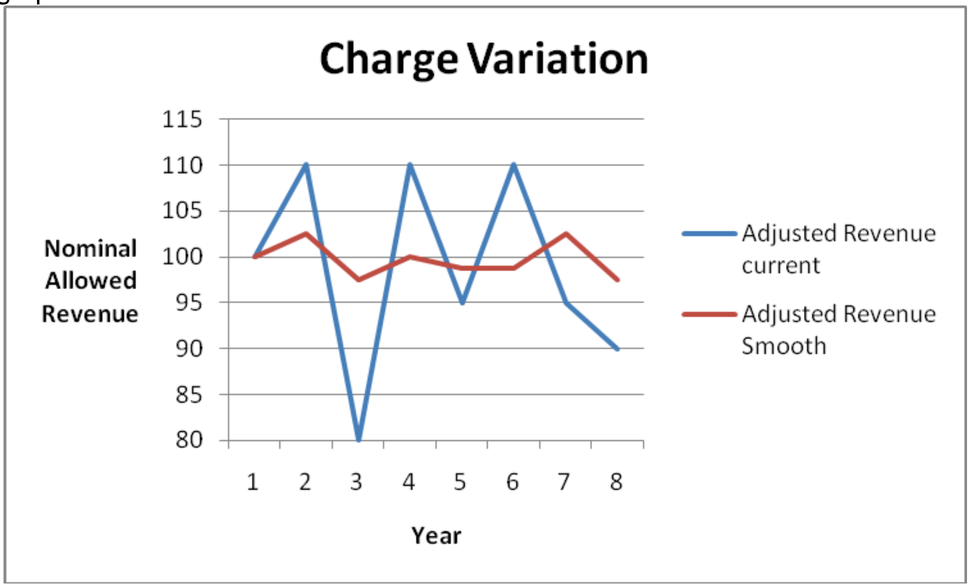
Year	1	2	3	4	5	6	7	8
Allowed Revenue at Start	100	100	100	100	100	100	100	100
Deviation in recovery	-10	20	-10	5	-10	5	10	0
Adjusted Revenue current	100	110	80	110	95	110	95	90
Collected Revenue (Current)	90	130	70	115	85	115	105	90
Sum Collected revenue	90	220	290	405	490	605	710	800

Proposed Solution

Year	1	2	3	4	5	6	7	8
Allowed Revenue at Start	100	100	100	100	100	100	100	100
Deviation in recovery	-10	20	-10	5	-10	5	10	0
Adjusted Revenue Smooth year 1		2.5	2.5	2.5	2.5			
Adjusted Revenue Smooth year 2			-5	-5	-5	-5		
Adjusted Revenue Smooth year 3				2.5	2.5	2.5	2.5	

Adjusted Revenue Smooth year 4					-1.25	-1.25	-1.25	-1.25
Adjusted Revenue Smooth year 5						2.5	2.5	2.5
Adjusted Revenue Smooth year 6							-1.25	-1.25
Adjusted Revenue Smooth year 7								-2.5
Total Adjustment	0	2.5	-2.5	0	-1.25	-1.25	2.5	-2.5
Adjusted Revenue Smooth	100	102.5	97.5	100	98.75	98.75	102.5	97.5
Collected Revenue (Smooth)	90	122.5	87.5	105	88.75	103.75	112.5	95
Sum Collected revenue	90	212.5	300	405	493.75	597.5	700	795

In graphical form below:



We would expect that any under or over-recovery that is still present at the end of the price control would be treated in the same manner as any variation is currently.

4 Relevant Objectives

The Proposer believes that implementation will better facilitate the achievement of **Relevant Methodology Objectives a, b, c and d.**

Proposer's view of the benefits against the Code Relevant Methodology Objectives	
Description of Relevant Objective	Identified impact
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;	None
aa) that, in so far as prices in respect of transportation arrangements are established by auction, either: (i) no reserve price is applied, or (ii) that reserve price is set at a level - (I) best calculated to promote efficiency and avoid undue preference in the supply of transportation services; and (II) best calculated to promote competition between gas suppliers and between gas shippers;	None
b) that, so far as is consistent with sub-paragraph (a), the charging methodology properly takes account of developments in the transportation business;	None
c) that, so far as is consistent with sub-paragraphs (a) and (b), compliance with the charging methodology facilitates effective competition between gas shippers and between gas suppliers; and	Yes. See below
d) that the charging methodology reflects any alternative arrangements put in place in accordance with a determination made by the Secretary of State under paragraph 2A(a) of Standard Special Condition A27 (Disposal of Assets).	None

Relevant Objective c) that, so far as is consistent with sub-paragraphs (a) and (b), compliance with the charging methodology facilitates effective competition between gas shippers and between gas suppliers.

Smoothing any variability year-on-year between charges will limit the impact any price changes on gas shippers. This will make costs more predictable, so reducing administrative costs incurred by shippers in handling price variations. This reduction in unnecessary costs to shippers will improve competition.

In the case of a modification to a DN Charging Methodology, please state why the modification does not conflict with paragraphs 2, 2A and 3 of Standard Special Condition A4 of the Transporter's Licence.

The modification does not alter the process by which the charging methodology statement is produced or variations to it are published.

5 Impacts and Costs

Costs

Indicative industry costs – User Pays
Classification of the proposal as User Pays or not and justification for classification
There is no change to the current processes undertaken by xoserve for this process, so it is not User Pays.
Identification of Users, proposed split of the recovery between Gas Transporters and Users for User Pays costs and justification
Not applicable
Proposed charge(s) for application of Users Pays charges to Shippers
Not applicable
Proposed charge for inclusion in ACS – to be completed upon receipt of cost estimate from xoserve
Not applicable

Impacts

Impact on Transporters' Systems and Process	
Transporters' System/Process	Potential impact
UK Link	None
Operational Processes	Charge Setting would have to take into account smoothing process.
User Pays implications	None

Impact on Users	
Area of Users' business	Potential impact
Administrative and operational	Users will be able to price transportation charges into their products with greater certainty, so reducing risk costs.
Development, capital and operating costs	None

Impact on Users	
Contractual risks	The level of charge variation will be reduced. This make any cost pass through more predictable so reducing the risk of non-payment
Legislative, regulatory and contractual obligations and relationships	None

Impact on Transporters	
Area of Transporters' business	Potential impact
System operation	None
Development, capital and operating costs	None
Recovery of costs	None
Price regulation	TBC
Contractual risks	None
Legislative, regulatory and contractual obligations and relationships	In order to ensure that the transporters are not penalised by this new regime, there will be a need to adjust Special Licence Conditions Part E to take into account the smearing of under and over-recovery over a four year period.
Standards of service	None

Impact on Code Administration	
Area of Code Administration	Potential impact
Modification Rules	None
UNC Committees	None
General administration	None

Impact on Code	
Code section	Potential impact
TBC	

Impact on UNC Related Documents and Other Referenced Documents

Where can I find details of the UNC Standards of Service?

In the Revised FMR for Transco's Network Code Modification **0565 Transco Proposal for Revision of Network Code Standards of Service** at the following location: http://www.gasgovernance.com/networkcodearchive/551-575/

Impact on UNC Related Documents and Other Referenced Documents	
Related Document	Potential impact
Network Entry Agreement (TPD I1.3)	None
Network Exit Agreement (Including Connected System Exit Points) (TPD J1.5.4)	None
Storage Connection Agreement (TPD R1.3.1)	None
UK Link Manual (TPD U1.4)	None
Network Code Operations Reporting Manual (TPD V12)	None
Network Code Validation Rules (TPD V12)	None
ECQ Methodology (TPD V12)	None
Measurement Error Notification Guidelines (TPD V12)	None
Energy Balancing Credit Rules (TPD X2.1)	None
Uniform Network Code Standards of Service (Various)	None

Impact on Core Industry Documents and other documents	
Document	Potential impact
Safety Case or other document under Gas Safety (Management) Regulations	None
Gas Transporter Licence	In order to ensure that the transporters are not penalised by this new regime, there will be a need to adjust Special Licence Conditions Part E to take into account the smearing of under and over-recovery over a four year period.

Other Impacts	
Item impacted	Potential impact
Security of Supply	None
Operation of the Total System	None
Industry fragmentation	None

Terminal operators, consumers, connected system operators, suppliers, producers and other non code parties	The volatility in the current charge setting process will be markedly reduced, so ensuring that transportation costs will be more predictable and reduce the exposure consumers have through their suppliers to volatile price variations.

6 Implementation

In order to maximise the benefits to the industry, we believe that this modification should be implemented from 1 April 2012 with any resulting under or over-recovery taken into account in the next price control in the same manner as any variance is under the current process. We do recognise that an optimal implementation may be the start of the new price control in 1 April 2013.

7 The Case for Change

Advantages

Provides certainty to the current charge setting process, so reducing the risk to consumers and shippers of unpredictable price changes.

Disadvantages

In order to ensure that the transporters are not negatively impacted by this change it will be necessary to alter the DN's licence conditions.

*

8 Recommendation

The Proposer invites the Panel to:

- DETERMINE that Modification 0370 progress to a Workgroup.