DISTRIBUTION NETWORKS PRICING DISCUSSION PAPER DNPD02

LDZ System Charges Capacity / Commodity Split and Interruptible Discount

A draft discussion paper on behalf of all Distribution Networks

1. Background

In February 2006 Ofgem published their document "Conclusions on the review of the structure of gas distribution charges". One of the conclusions of this document was that increasing the proportion of capacity-related charges would better reflect the actual balance of capacity and commodity related costs of gas distribution. More cost-reflective charges would have a significant impact on the efficient use of the distribution assets and help reduce future investment costs. These savings would eventually be reflected in lower charges to all customers. A higher proportion of capacity related charges would also bring additional benefits to users in the form of more stable charges.

Since then the DNs have undertaken a review of the factors which result in variations in their costs. The results of these analyses suggest that only around 5% of the DN's cost base varies with the volume of gas transported. The remainder of the costs are either related to the development and maintenance of the transportation network, for example building a new pipeline, or not directly related to transportation of gas, for example support departments' costs such as Finance or Human Resources.

Based upon this latest cost driver analysis, the DNs are considering changing the split of the LDZ system charges to provide a more cost reflective capacity / commodity split of around 95:5. The current target split is 50:50. Note that no change to the customer charges is being considered as part of this proposal.

Due to the structure of the current interruptible customer discount, the interactions between interruptions arrangements and the capacity / commodity split need to be taken into account when considering this change.

Currently, interruptible customers are compensated via a waiver of their LDZ capacity charges. In addition these customers receive a rebate when their supply is interrupted for more than 15 days. This rebate is calculated at 1/15 of their nominal capacity charge for each additional day that they are interrupted above 15 days.

If the proportion of LDZ system charges levied via capacity charges is increased, this could lead to a disproportionately large, non cost reflective discount for interruptible customers. The methodology considered in this paper would maintain the effective level of the discount to interruptible customers at the present level.

This discussion paper is published at this time in order to obtain the views of shippers and others in the community on the likely change and its timing, and in order to give a year's notice ahead of its likely implementation time. Subject to considering the views of respondents, the DNs propose to bring forward a consultation paper including the definitive proposal by summer 2007 with a planned implementation date of 1st April 2008.

The proposal is supported by all the DNs.

2. Proposal

2.1 To change the structure of the LDZ system charges to a more cost reflective 95:5 capacity/commodity split

The capacity / commodity splits of the LDZ system charges under the current and the proposed methodology are set out in the table below:

Table 1 –Capacity / commodity split under current and proposed methodology

	Current Methodology	Proposed Methodology
	% Revenue	% Revenue
Capacity	50	95
Commodity	50	5
Total	100	100

All the DNs would implement the change at the same time in order to maintain a common DN charging methodology.

2.2 Interim charging methodology for interruptible sites

At present, interruptible loads do not pay LDZ system capacity charges. As a result, increasing the capacity element of the LDZ system charges without any other changes would result in interruptible loads receiving a disproportionately large discount on the LDZ transportation charges. Given the decision on Mod 0090 to introduce a new interruption regime in a few years, no fundamental revaluation of the appropriate level of interruptible discount has been undertaken. It is therefore proposed to maintain the current level of LDZ system capacity charge discount for interruptible loads as at present.

This could be achieved by moving from a 100% discount on LDZ system capacity charges to a 52.6% discount on LDZ system capacity charges (a value equivalent to the existing 50% capacity discount as a proportion of the 95% capacity charge element). At this level, combined with the LDZ system commodity charges, the size of the current interruptible discount would be maintained.

It should be noted that the structure of the capacity commodity split will not impact upon the contracting for interruptible rights in the future as laid out in Mod 90.

2.3 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
The analyses by the DNs indicate that the majority of variable costs relate to the provision of capacity with only a low level of cost relating to the gas throughput. The proposed structure of charges would therefore be significantly more cost reflective than the current structure.

(c) Facilitating Competition
The proposed change would facilitate competition in gas supply by removing a source of instability in the charges. More stable charges should reduce the uncertainty and instability of the distribution transportation charge element within shippers' and suppliers' cost bases. This should improve the efficiency of the gas supply market and stimulate competition.

3. Impact of Change

3.1 Distributional Effects

The distributional effect of the proposed change on specific loads will depend on load factors rather than on AQs. Loads which have a lower load factor than the Network average are likely to experience a small increase in their total charges, whereas loads which have a higher load factor than the network average will experience a reduction. Overall the new charges would be set to recover the same level of revenue as the existing charges. A large number of small loads, which tend to have low load factors, will experience small increase, whereas a small number of large loads with high load factors will experience reductions.

The DNs do not anticipate that this change will require amendments to the transportation billing mechanisms managed by xoserve for firm sites. An amendment to the billing systems is likely to be required for interruptible sites. Xoserve are investigating if any change to the invoice file formats will be required.

3.2 Impact on IGTs

IGTs' maximum transportation charges are constrained by the Relative Price Control under which the maximum the IGT can charge is based on the difference between the DN Transportation charges to the CSEP and the sum of the charges to the individual loads on the network if they were directly connected DN loads. Our initial analysis suggests that the rebalancing of the capacity / commodity split in favour of a greater capacity weighting will have a minimal impact upon the IGT's. This is because the rebalancing of the capacity / commodity split will have an approximately equivalent impact upon both sets of charges due to the same load factors being used in each.

4. Implementation of the change

The DN Licence places a reasonable endeavours obligation upon the DNs to only make changes to the charges and charging methodology on the 1st October. However all of the DNs consider that there is considerable merit in introducing the proposed change on 1st April 2008, the beginning of a formula year. This would enable the charge to be set at the appropriate level for the full formula year which will help to make the charge more stable.

The problem with rebalancing the capacity / commodity split in the middle of a formula year (October) is that a commodity charge raises about one third of its revenue in the first half of the formula year and two thirds in the second half, whereas the flow of revenue from a capacity charge is even through the year. If the capacity / commodity split were rebalanced on 1st October, the charges would need to be set at a level to recover two thirds of the target revenue in the period October to March. This level would then be too high for the subsequent full year so the charge would need to be reduced at the first opportunity. Implementing the change on 1st April would avoid this source of instability and provide shippers with a more stable charge.

The introduction of the change from the 1st April 2008 would also align the charging methodology with the start of next price control period and would bring the benefits of price stability as soon as practicable.

Introduction of the charging methodology change from 1st April 2008 rather than 1st October will require direction from Ofgem.

5. Points for Discussion

The DNs would welcome responses to the following issues:

a) Should the Charging Methodology be changed so that the capacity element of the LDZ System charges is set to recover around 95% of the revenue from the LDZ system charges for all DNs?

b) Should this change be made with effect from 1st April 2008?

c) Should Interruptible customers pay a proportion of the increased LDZ capacity charge such that their effective discount on total LDZ Firm charges maintains the status quo?

d) Are there any other factors that the DNs should consider in their review of the LDZ system charges split between capacity and commodity elements?