



Office of Gas and Electricity Markets
www.ofgem.gov.uk

The Joint Office, Transporters,
Shippers and other interested
parties

Our Ref: Net/Cod/UNC073
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Dear Colleague,

Modification Proposal UNC073: Revision to the Notice Period regarding the implementation of changes to Transportation Charges.

Having considered the issues arising from this proposal Ofgem¹ has decided not to direct the implement the modification, as Ofgem does not believe that it will better facilitate the achievement of the relevant objectives of the Uniform Network Code (UNC), as set out in standard special condition A11² of relevant Gas Transporters Licences as compared with the existing provisions of the UNC.

This letter explains the background to the modification proposal and outlines the reasons for Ofgem's decision.

Background

Currently, Transporters levy transportation charges (e.g. capacity and commodity charges) on users of the National Transmission System (NTS) and Local Distribution Zones (LDZ) to recover the allowed revenue determined under their price controls. The charging methodology for recovering annual allowed revenue from system users is governed by obligations set out in the Transporters GT licence. In particular, Transporters are required to ensure that their charges reflect the costs incurred in transporting gas. Transporters are also required to use best endeavours to set transportation charges such that actual revenue collected from charges does not exceed the price controlled allowed revenue in any given year.

Transporters may from time to time make changes to the manner in which they recover allowed revenues through its charges. Any changes to these arrangements would need to be initiated by Transporters through a pricing consultation proposal and would need to be consistent with the relevant charging methodology objectives set out in Standard Special Condition 4A of the GT licence.

¹ Ofgem is the Office of the Gas and Electricity Markets Authority. The terms 'Ofgem' and the 'Authority' are used interchangeably in this letter

² This Licence Condition can be viewed at:

http://62.173.69.60/document_fetch.php?documentid=6547

Transporters may also periodically adjust the level of their transportation charges. For instance, because entry capacity is sold through an auction mechanism, where revenues received in these auctions suggest that a Transporter may fall short of its allowed revenue for a particular year, the TO commodity charge is used as a mechanism to rebalance revenue to ensure the Transporter does not under recover against the allowed revenue.

Transporters are required to provide notice of change to charges to the Authority and Users, as follows;

- Under the provisions of *Standard Special Condition 4* of the GT licence Transporters must use reasonable endeavours to give the Authority notice of a proposal to change their charges at least 150 days before the proposed date of implementation. Once the Transporter has received the consent of the Authority to make changes to its charges, it must give the Authority one month's notice of the date on which the changes will be implemented; and
- The UNC sets down a two month Notice Period for informing Users of changes to charges pursuant to *Standard Special Condition 4A(2)* of the Transporters Licence.

There have been three past modification proposals raised to change the notice period regarding the implementation of changes to the transportation charges. Two³ of these proposals were for temporary waivers of the notice period to deal with particular circumstances, and therefore are not particularly relevant to the consideration of this proposal, which would apply to all changes to transportation charges.

Network Code Modification Proposal 655⁴ was rejected by Ofgem on 17 March 2004. This proposal sought to oblige Transco (as it then was) to publish changes to transportation charges with at least three months notice and also obliged Transco to publish indicative prices six months prior to implementation. We did not consider that the proposal would effectively address shippers' and suppliers' concerns regarding the potential uncertainty and volatility of Transco's charges, the frequency of within year changes and the lack of detail surrounding Transco's charges and revenue flows.

The Proposal

Corona Energy raised modification proposal 073 on 3 February 2006. Modification proposal 073 seeks to extend the notice period for informing Users of changes to transportation charges from 2 to 4 months. The Proposer considers that increasing the notice period for informing Users of transportation price changes would better facilitate the achievement of the relevant objective (d) as set out in paragraph 1 of Standard Special Condition A11 in the Gas Transporters licence⁵, as all suppliers would be able to accurately factor into supply contracts the impact of transportation charge changes.

³ Network Code Modification 486 'Waiver of notice period for implementation of changes to transportation charges' which was accepted by Ofgem on the 24 August 2001 and 536 'Temporary waiver of two months notice period to effect a change to Transco's Transportation charges' was rejected by Ofgem on the 16 May 2002

⁴ http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/6534_655.pdf

⁵ The securing of efficient competition between relevant shippers, suppliers and DN Operators

Respondents' views⁶

Three parties expressed support for modification proposal 073, one qualified support, and eight were against the implementation of the proposal.

Consumer contracts

Some of the respondents who were in favour on the modification considered that the current notification arrangements do not sufficiently allow for transportation charge changes to be accurately factored into supply contracts. In the absence of contracts which enable suppliers to pass through under or over recovery of transportation costs to customers, these respondents considered that the notification arrangements;

- prevent customers from realising the benefit of lower than forecast transportation costs;
- expose suppliers to additional costs in a highly competitive, low margin market; and
- allow small suppliers, particularly those with a geographically biased customer portfolio to face a disproportionate price risk.

The respondents who were in favour of the proposed modification therefore considered that the proposed extension of lead times for the notification of transportation charge changes would enable suppliers to adjust the customer price to reflect the charges actually levied. These respondents did not consider that a movement of the deadline for publishing final charges by Transporters would significantly reduce their accuracy, and considered that price certainty would facilitate competition between suppliers.

A number of respondents who did not support the modification proposal considered the proposals perceived benefits would only provide certainty in charges in the short run and thus would be beneficial to only those shippers who set supply contracts with consumers at short notice (2 to 3 months) and on a frequent basis. These respondents therefore considered that any benefit from 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.

In addition, these respondents considered that the proposal to extend the notice period would not allow sufficient time for Transporters to utilise information, such as the current forecast of transportation volumes for the networks and the outcome of the demand forecasting cycle when calculating the new transportation charges. These respondents considered that forecasts would need to be used by Transporters instead of actual data, which would mean that the proposed changes in transportation charges would be less accurate in terms of making appropriate adjustments to minimise the risk of significant under or over recovery, and thus creating a source of uncertainty that would have to be corrected in the future.

Volatility in transportation charges, frequency of change in charges and the accuracy and variability of transportation charges

⁶ This section is intended to summarise the principal themes of the respondents' views and is not intended to provide a comprehensive overview of the responses received. These can be found on the Gas Transporters information service (formally known as Nemisis) <https://gtis.gasgovernance.com>

Some of the respondents who were in favour of the proposed modification expressed concerns that Transporters may choose to reset transportation charges within any gas year if initial forecasts of revenue recovery were not being met. These respondents considered that many of the benefits for customers and efficiencies for suppliers would be undone if this were the case, and considered that re-setting charges should be avoided wherever possible. One respondent considered that appropriate incentives already existed for Transporters to encourage accurate forecasting of revenue recovery and discourage an overly cautious approach to the initial setting of charges. This respondent considered that if the modification was implemented there may be reduced volatility as a level of smoothing is experienced year on year.

Another respondent, who expressed qualified support for the modification proposal expressed concern that given the best endeavours obligation for Transporters to set charges accurately, the implementation of this proposal would run the risk of counteracting the stability of changes to charges, through more frequent adjustments to the level of transportation charges by Transporters to avoid incurring penalties for under or over recovery.

Some respondents who did not support the modification proposal considered that it may make subsequent transportation charge changes larger and more likely to occur, which would continue into future periods. These respondents considered that such transportation charge volatility was not beneficial for the wider market and could potentially hinder customer's ability to effectively compare prices. The proposed modification was considered to exacerbate supplier issues, by introducing more inaccurate and variable transportation charges, therefore amplifying the fluctuations between years and reducing the predictability of charges.

Panel recommendation

At the modification panel meeting of 16 March 2006, of the ten voting members present, capable of casting ten votes, three votes were cast in favour of implementing modification proposal 073. Therefore the panel did not recommend implementation of this proposal.

Ofgem's view

Ofgem supports the principle of transparency in transportation charges and understands the concerns of some shippers that the current notice periods for changes in charges lead to some risk for shippers when forecasting transportation charges. However, the desire for longer notice periods for shippers would mean that Transporters forecasts for setting charges would use less up to date information, thereby increasing the risk of under or over recovery of allowed revenue, and therefore, the risk of subsequent changes in transportation charges within a charging year to correct an under or over recovery. This could increase the volatility of transportation charges within year or lead to a misallocation of costs between years which could have a detrimental effect on competition between shippers.

Whilst we understand the concerns that led to the making of modification proposal 073, we believe that the proposal may introduce instability and uncertainty within the Transporters transportation charging arrangements by not providing sufficient time for Transporters to utilise the most accurate data. We therefore do not consider that modification proposal 073 will strike a more reasonable balance than the current provisions, in providing shippers with sufficient notice of changes to charges whilst also

allowing Transporters to have the best possible information on which to forecast actual revenues each year.

Ofgem recognises the importance of stability and certainty of charges for customers and suppliers. However we do not consider that the modification would provide the benefits that it seeks to attain and therefore would not better facilitate competition between shippers and suppliers compared to the current UNC provisions. Nevertheless Ofgem would support consideration of Transporters publishing more information to assist suppliers in understanding the likelihood that charges may change during the year or in the next year due to expected under or over recoveries.

Ofgem's decision

For the reasons outlined above, Ofgem has decided to reject modification proposal 073.

If you have any queries in relation to the issues raised in this letter, please feel free to contact me on the above number.

Yours sincerely



Nick Simpson

Director, Industry Codes and Licensing