Modification proposal:	**Uniform Network Code (UNC): Implementation of DNPC03 (LDZ system charges – capacity / commodity split and Interruptible discounts), the alignment of failure to Interrupt charges and the alignment of the IFA charge (UNC210)**		
Decision:	The Authority[1] directs that this proposal be made[2]		
Target audience:	The Joint Office, Parties to the UNC and other interested parties		
Date of publication:	27 August 2008	Implementation Date:	To be confirmed by the Joint Office

Background to the modification proposal

Use of System charges recover costs that relate to the provision, maintenance and operation of the distribution network. Revenue is collected from separate charges based on customer's peak network capacity requirements (i.e. capacity based) and actual use of gas (commodity based) : the former being collected on the basis Supply Offtake Quantity (SOQ), (also referred to as Supply Point Capacity), with the latter being collected based on annual gas consumption.

We conducted a review of the structure of gas distribution Use of System charges over the period May 2004 to February 2006. This considered, amongst other issues, shifting the balance of those charges towards a more capacity based charging system. We concluded that in principle such a rebalancing would better reflect GDN's costs allowing the Gas Distribution Network (GDN) operators to fulfil better the objectives of their charging methodology, as set out in the Gas Transporter (GT) licence. However, we also concluded that rebalancing should only occur following reform of interruption arrangements on distribution networks, as in the absence of such reform rebalancing could result in some customers with interruptible supply points benefiting from excessive charging discounts at the expense of other, non-interurptible customers.

On 15 March 2007 the Authority directed implementation of UNC 090 introducing reformed interruption arrangements on distribution networks, which will become fully operational on 1 October 2011 (the first set of competitive tenders were held recently in June 2008)_. This was followed by the GDNs issuing a joint pricing consultation DNPC03[3] in July 2007. Subsequently, Ofgem received a final proposal from the GDNs on 13 September 2007 to amend their charging methodologies with effect from 1 October 2008 so that:

- the proportion of revenue collected from Use of System ***capacity charges*** increases from 50% to 95%, while the proportion collected from Use of System ***commodity charges*** decreases from 50% to 5%; and

- interruptible supply points to pay capacity charges equal to 47.37% of those paid by an equivalent firm connection, so maintaining the existing value of capacity charge discounts received by these supply points.

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[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] *'LDZ system charges – capacity/commodity split and interruptible discounts'*

On 13 December 2007 Ofgem published its decision not to veto the proposal[4], in conjunction with a Final Impact Assessment supporting the increase in the capacity element of Use of System charges.

Rebalancing Use of System Charges is implemented by amending each GDNs charging methodology and not through any amendment of the UNC. However, the change in the charging methodologies will have the following unintended consequences on two UNC defined charges levied by GDNs on interruptible users from 1 October 2008:

- the Failure to Interrupt (FTI) charge would increase by 90%: the existing FTI charge for the first day of failure to interrupt is calculated by multiplying the applicable annual firm capacity charge by two. As capacity charges increase to 95% of total Use of System charges the applicable annual firm capacity charge will increase the FTI charge by 90%; and

- the Interruption Firm Allowance (IFA) charge would increase by 53%: the existing IFA charge is levied on interruptible users who have a firm allowance of not more than 6,500 therms per day. The introduction of capacity charges for interruptible supply points will increase the IFA charge by 53%.

In addition UNC Transition Document Part IIC[5] currently states that interruptible users are exempt from paying either NTS exit capacity charges or Use of System capacity charges. The exemption from Use of System capacity charges is inconsistent with the amended charging methodology that states that as from 1 October 2008 interruptible users will pay a proportion, equivalent to 47.37% of the Use of System capacity charge, until these charging arrangements are superseded by interruptible auction arrangements in 2011.

The modification proposal

Wales and West Utilities (WWU) raised modification proposal 210 in order to implement DNPC03 within the UNC and to address the unintended consequences brought about by the amendment to the GDNs' charging methodologies. The proposal has four parts:

- to amend the calculation of the FTI charge so that interruptible supply points pay GDNs two times the difference between the Applicable Annual rate of the Use of System capacity charge (as introduced by DNPC03) and the Firm Applicable Annual rate, such that the current level of the FTI charge is maintained;

- to amend the calculation of the IFA charge so that interruptible supply points make a single payment to GDNs each October based on the Use of System capacity charge (based on the firm allowance) less any capacity payments expected over the subsequent 12 months made in respect of the firm allowance and paid as interruptible Use of System capacity charge (resulting from the implementation of DNPC03);

- to amend paragraph 9.1.9 to remove interruptible users exemption from paying Use of System capacity charges; and

[4] http://www.ofgem.gov.uk/Networks/GasDistr/GasDistrPol/Documents1/Decision%20Letter%20on%20DNPC03%2013Dec07.pdf
[5] Paragraph 9.19(a)

- the proposer has also identified, and seeks to remedy as part of this proposal, incorrect numbering within the UNC Transition Document Part IIC paragraph 10.4.2, to the effect that a reference within that paragraph to paragraph 10.5.3 should instead read 10.4.3.

UNC Panel[6] recommendation

At its meeting on 19 June 2008, the UNC Modification Panel voted by a panel majority to recommend the implementation of this proposal.

The Authority's decision

The Authority has considered the issues raised by the modification proposal and the Final Modification Report (FMR) dated 22 July 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 FMR[7]. The Authority has concluded that:

1. implementation of the modification proposal will better facilitate the achievement of the relevant objectives of the UNC[8]; and

2. directing that the modification be made is consistent with the Authority's principal objective and statutory duties[9].

Reasons for the Authority's decision

The Joint Office received fifteen responses to its consultation on UNC210, of which ten were supportive and five were opposed to the proposal. Those in support considered that the proposals implement fully the amendment to the charging methodologies following the "Joint GDN Charging Modification Proposal DNPC03" which the Authority chose not to veto on 13 December 2007, and seeks to ensure consistency in users paying the same level of FTI and IFA charges. They also supported removing the capacity charge exemption for interruptible supply points in order to facilitate the introduction of the proportionate capacity charge that such supply points will have to pay from 1 October 2008. These measures would ensure that there is no inappropriate discrimination between different market sectors and that charges and discounts to interruptible supply points remain unchanged following the increase in the proportion of Use of System capacity charges. As such they considered that the proposal would further the relevant objectives of the UNC.

The main argument against the proposal related to the removal of the exemption from Use of System capacity charges for interruptible supply points. Three respondents with interests in embedded gas storage, that are registered as interruptible supply points represented one group opposed to the proposal. They considered that introducing Use of System capacity charges for interruptible supply points could render existing and

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

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

[8] 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

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

potential embedded storage projects unviable, thereby removing an additional and alternative source of gas from the market.

One respondent believed that the needs of storage sites had not been given sufficient consideration when the modification proposal was being developed. Consequently they considered that implementation should be posponed so that further consideration could be given to such sites.

A further two respondents with interests in a power generation plant running an open cycle gas turbine (OCGT) facility, again registered as an interruptible supply point, expressed their opposition to the proposal. They considered that due to the operational characteristics of the plant, which require having a high system offtake quantity relative to annual consumption, means that removing the Use of System capacity charge exemption discriminates against them by not maintaining the existing value of the capacity discount, as outlined in DNPC03. While we consider this assertion to be factually incorrect, we do recognise that total Use of System charges will increase for such supply points.

The concerns raised around the increase in distribution charges for interruptible supply points appear to relate to our decision not to veto the GDN's DNPC03 proposal to amend their charging methodologies and not to the matters raised by UNC210. UNC210 seeks to deal with implementation issues and unintended consequences following the Authority's Decision on DNPC03. In reaching our decision on DNPC03 we recognised as part of our Final Impact Assessment that the impact of the proposal on individual supply points would be a function of the relationship between Supply Offtake Quantity and annual consumption. Overall however we considered that the distributional effects this would have were justified in principal and would facilitate the economically efficient development of the pipeline system.

While we acknowledge the concerns of those who will face higher distribution charges, for the reasons set out above we have not attached significant weight to them in our consideration of whether to accept or reject the modification proposal. In reaching this view, we also note that there may be opportunities for these concerns to be addressed through further changes to the charging methodology. GDNs have a licence obligation to keep their charging methodology under review to ensure that it continues to facilitate the achievement of the relevant objectives as set out in Standard Special Condition A5 of the Gas Transporter licence. Should stakeholders have new evidence that supports further amending the charging methodology they should provide this to the Distribution Charging Methodology Forum for due consideration.

We set out below the reasons why we have concluded that the proposal would better facilitate the relevant objectives is given below:

Relevant Objective (a) – the efficient and economic operation of the pipe-line system to which this licence relates;

We concur with the proposer and those respondents who stated that by facilitating the implementation of DNPC03 this proposal may be expected to facilitate this relevant objective and ensure the efficient and economic operation of the pipe-line system. We consider that removing the Use of System capacity charge exemption for interruptible supply points in order to facilitate the introduction of the proportionate Use of System capacity charge for such supply points will encourage more accurate SOQ nominations. Under the current regime there is little incentive for an interruptible supply point to nominate an accurate SOQ as they do not pay Use of System capacity charges. Once interruptible supply points begin to pay Use of System capacity charges, even at the reduced rate, booked capacity will better reflect actual requirements. In turn we consider that a more accurate SOQ nomination will facilitate more efficient and economic network development.

One respondent opposed to the proposal considered that the modification would not maintain the current level of FTI charges, but would result in charges that would be in excess of double the amount required to achieve this objective. However, they did not provide a detailed explanation for this view. We do not consider this to be correct analysis as the proposed modification would maintain the FTI charge at current levels.

Relevant Objective (c) –the efficient discharge of the licensee's obligations under this licence;

In line with the views of the proposer and the respondents who expressed support for the proposal we agree that implementation of UNC210 will ensure that an appropriate charging methodology is in place after the 1 October 2008 changes, which will make it consistent with the Standard Special Condition A5 of the GT licence. We agree that the FTI and IFA charges need to be revised in order to ensure that their level remains unchanged.

Three respondents considered that implementation of the proposal would not facilitate the relevant objectives as the proposed Use of System capacity charge will not reflect the costs associated with moving gas to and from an embedded storage site. They considered that since the users of these facilities will be entering gas onto rather than offtaking gas from the system during peak gas demand they do not impose a system cost. On this basis they considered that users should not be charged for capacity in the same way as other GDN customers. They cited the Connected System Exit Point (CSEP) charge and the short-haul tariff as examples of how other offtakes are treated in a differential manner to the majority of GDN connected points, as such a methodology specific to the costs of an embedded storage site should be developed instead.

Again, many of the concerns expressed by respondents opposed to UNC210 appear to lie outside the scope of the UNC210 proposal, and while we have taken these on board, we have not attached significant weight to them in our consideration of whether to accept or reject the modification proposal. These responses appear to be concerned with the content of DNPC03 and our decision not to veto the proposal rather than with UNC210 which seeks to deal with implementation issues and unintended consequences.

Relevant Objective (d) – the securing of effective competition;

We support the assertion of the proposer that implementation of appropriate charging methodologies will help to ensure that there is no undue discrimination between different market sectors and that, in this instance, interruptible supply points are not in receipt of inappropriate 'discounts' or subject to inappropriate FTI and IFA charges. We therefore agree that the implementation of this modification proposal will better facilitate this relevant objective.

Opponents to the modification proposal considered that it will adversely affect new entities entering the market. One respondent considered that its own interruptible supply point will face higher charges that are disproportionate and discriminatory.

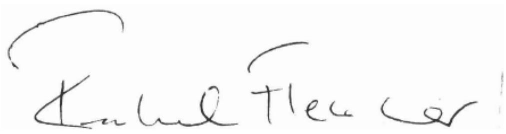
Once again, we consider that such concerns directly relate to DNPC03 and the Authority's decision not to veto its proposals. While we have taken these comments on board, we have not attached significant weight to them in our consideration of whether to accept or reject the modification as they appear to lie outside the scope of the UNC210 proposal.

Relevant Objective (f) – so far as is consistent with sub-paragraphs (a) to (e), the promotion of efficiency in the implementation and administration of the network code and/or the uniform network code;

We agree that implementation of this proposal will ensure that any further changes to the balance of Use of System charges will not require a UNC modification proposal to re-align the first day FTI charge or the IFA charge. Therefore implementation of this proposal will better facilitate this relevant objective.

Decision notice

In accordance with Standard Special Condition A11 of the Gas Transporters Licence, the Authority, hereby directs that modification proposal UNC 210: '*Implementation of DNPC03 (LDZ system charges – capacity / commodity split and Interruptible discounts), the alignment of failure to Interrupt charges and the alignment of the IFA charge*' be made.



Rachel Fletcher,
Director of Distribution
Signed on behalf of the Authority and authorised for that purpose.