

Modification proposal:	Distribution Network Pricing Consultation DNPC08: Review of Standard LDZ System Charges		
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:	26 January 2011	Implementation Date:	01 April 2012

Background to the modification proposal

The transportation charges levied by gas distribution networks (GDNs) for use of their networks are split into two components, the system charge and the customer charge. Broadly the system charge is intended to recover the cost of the upstream network whilst the customer charge is intended to recover the cost of the local network and customer related costs. Roughly 70% of the transportation part of a customer's bill is the system charge with the remainder being the customer charge.

The current transportation charging methodology was established in 2001. At this time all GDNs were owned by a single company, Transco.³ As a consequence of this the GDN charging methodology is common across GDNs and the data that underpins it reflects the average network characteristics of all GDNs. Since the methodology was established four of the GDNs (sometimes referred to as the regional distribution networks – RDNs) have been sold to other companies.

The GDN methodology for calculating system charges allocates total network cost to pressure tiers and then to four broad categories of customer⁴ based on the average point of connection⁵ of customers within each category and their utilisation of the pressure tier at peak times. These costs are then charged to customers within these broad categories on the basis of the amount of network capacity they have booked and the volume of gas they consume (the commodity charge).

The GDNs are undertaking a process of updating their transportation charging methodology to try and improve its cost reflectivity and reflect developments in their businesses, notably after DN sales. In January last year we decided not to veto a proposal to base the split between cost allocated to the system and customer charge on GDN specific rather than national cost data.⁶ The GDNs have also submitted along with the DNPC08 modification report a proposal to change the split of the system charge between its capacity and commodity elements. In addition we understand that over the coming months the GDNs will also undertake a review of the customer charge element of the transportation charge.

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 The PC68 Decision Letter can be found here: <http://www.nationalgrid.com/NR/ronlyres/84FFB8AA-AOF2-48F4-A6C9-C2C81B67E285/4884/PC68andPC71Ofgemdecision.pdf>

⁴ These are: customers consuming between 0-73.2 MWh per annum; customers consuming between 73.2-732 MWh per annum; customers consuming over 732 MWh per annum and connected system exit point (CESP) customers.

⁵ I.e. on average the pressure tier to which customers in each category are connected.

⁶ The DNPC05 Decision Letter can be found here:

<http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?file=Decision%20Letter%20DNPC05%20Sent.pdf&refer=Networks/GasDistr/GasDistrPol>

The modification proposal

DNPC08 proposes that the Standard Local Distribution Zone (“LDZ”) System Charges methodology be modified so that the system charges are calculated using the network characteristics of each GDN. The proposal is to estimate the average network characteristics for GDNs using data collected over the period 2008-2010. This differs from the current methodology which uses national average network characteristics to calculate transportation using data collected prior to 2001. In particular DNPC08 proposes to update the following analysis:

1. The connection probability analysis – where a sample of data on the connection point of each of the four categories of customer is used to establish on average the probability that a consumer in a category used a network tier;
2. The gas flow analysis – where a sample of data on network flow is used to establish the usage on average of a network tier by each customer category; and
3. Update of fitted functions used to calculate capacity charges for customers consuming greater than 732,000 MWh per annum.⁷

The cost allocation methodology that is used to allocate cost to network tiers is also updated slightly. This is to reflect changes in the accounting procedures of the GDNs which are, in part, necessitated by changes in their regulatory reporting requirements.

The modification report notes that larger sample sizes are used in update of the analysis outlined in points 1 to 3 above than were used in the corresponding analysis from 2001 used to calculate national average values. The larger sample size provides a greater degree of confidence in the accuracy of the estimate of average network characteristics.

With regard to point 3 above the report states that a number of functional forms were used to estimate the best relationship between p/kWh/peak day and system offtake quantities (SOQs). The report notes that whilst the existing functional form did not provide the best fit in all cases the improvements in fit provided by alternative functional forms was very small and not sufficient to justify the costs shippers would have to make to their systems.

One consequence of the proposal is to essentially rationalise the number of customer categories from 4 to 3. Previously Closed Service Exit Point (CSEP) customers had been treated differently from other customers with equivalent annual consumption with essentially lower system charges. However the report argues that the updated analysis shows that CSEP customers are insufficiently different from other customers to justify this. It is proposed that CSEP customers will be treated the same as customers with equivalent annual consumption for transportation charging purposes.

This modification proposal is intended to better achieve the relevant methodology objectives of Standard Special Condition (SSC) A5 (5)(a) and SSC A5 (5)(b) we consider that the proposal is neutral regarding objective SSC A5 5(c) and not relevant to SSC A5 (5)(aa) or SSC A5(5)(d)⁸. The GDNs argue that the proposal will improve the cost reflectivity of transportation charges and reflects developments in their businesses. An implementation date of 1 April 2012 is proposed.

⁷ For customers with an annual consumption of greater than 732,000 MWh per annum the p/MWh/peak day values are mapped to system offtake quantity (SOQ – the chargeable measure of capacity) using a fitted function.

⁸ As set out in Standard Special Condition A5(5) of the GDNs’ licences, see: http://epr.ofgem.gov.uk/document_fetch.php?documentid=14192

The Authority's decision

In coming to a decision we have evaluated the proposal against the relevant objectives and our wider statutory duties. We have also considered views that were raised in response to the GDNs' consultation of DNPC08. We have considered the issues raised by the change proposal, the GDNs' consultation⁹ and the GDNs' final report¹⁰ issued on 29 December 2010. The Authority has concluded that:

1. DNPC08 should be implemented;
2. implementation of DNPC08 will better facilitate the achievement of relevant methodology objectives (a) and (b); and
3. DNPC08 is also consistent with the Authority's principal objective and statutory duties.¹¹

Reasons for the Authority's decision

For the reasons outlined below we consider that the proposal better facilitates the achievement of relevant objectives (a) and (b) and is neutral against objective (c). We consider this modification proposal is not relevant to objectives (aa) and (d).

We consider that objective (aa) is not relevant to this proposal. Objective (aa) refers to auctions; this proposal does not introduce or amend any arrangements related to setting prices based on an auction. We consider that objective (d) is not relevant as this modification proposal does relate to the disposal of assets in accordance with SSC A27.

SSC A5 (5)(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.

The GDNs argue that using network specific data to estimate average network characteristics when calculating transportation charges will mean that they better reflect the costs incurred by the licensee.

Three respondents to the GDN consultation on this proposal¹² supported moving to a charging structure that reflected network rather than national costs. Four respondents argued that it would not necessarily result in more cost reflective charging because the proposal only used a limited number of years of data to estimate network characteristics.

We consider that the proposal will mean that transportation charges will better reflect the cost incurred by the licensee because the proposal, in calculating transportation charges, uses data that reflects network characteristics at a GDN rather than a national level; and uses a larger sample size so that the estimated average network characteristics will be more accurate.

We also consider it appropriate that CSEP customers are treated in the same way as other customers with equivalent annual consumption for charging purposes. This is because the evidence presented by the GDNs suggests that their point of connection and

⁹ The GDNs Consultation on DNPC08 is available here:

<http://www.gasgovernance.co.uk/sites/default/files/02%20September%202010%20Consultation%20Paper%20v4.0.pdf>

¹⁰ The GDN's Final Report is available here:

<http://www.gasgovernance.co.uk/sites/default/files/DNPC08%20Consultation%20Report.pdf>

¹¹ The Authority's statutory duties are wider than matters that the Panel must take into consideration and are detailed mainly in the Gas Act 1986 (as amended) as well as obligations arising under EU legislation.

¹² Responses to the consultation can be found here: <http://www.gasgovernance.co.uk/dnpc08>

average network utilisation does not differ, on average, from other users in a manner that would justify a lower system charge. In addition we have noted the changes in the cost allocation methodology and consider that it is reasonable and reflects current regulatory reporting requirements.

We therefore consider that the proposal better facilitates relevant methodology objective (a).

SSC A5 (5) (b): that, so far as is consistent with sub-paragraph (a), the charging methodology properly takes account of developments in the transportation business;

The GDNs argue that the proposal will better facilitate objective (b) because implementation of the proposal will “reflect changes in the data since 2000”. We consider that changes in the data will to an extent reflect developments in the transportation business but this is more relevant to better facilitating objective (a). However, we do consider that the proposal will better achieve relevant objective (b) because calculating transportation charges based on network specific characteristics reflects the more independent operation of these networks since DN sales.

SSC A5 (5) (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.

Some shippers in their response to the GDNs’ consultation suggested that the proposal would have implications for competition amongst shippers. These shippers felt that the proposed changes to the methodology to reflect network differences in charges would impose cost on the shippers because of the need to update their systems and to explain changes in charges to customers. Whilst we are keen to ensure that network charging arrangements do not impose any unnecessary cost on shippers, in the case of this proposal we consider that any additional cost will be relatively small. We also consider that any impact on the cost to shippers will be outweighed by providing more accurate signals to customers regarding the cost of transportation services provided in the area that they are connected.

Consumer Impacts

We note that the impact analysis provided by the GDNs is that there will be an increase in the system charge for “typical” customers in the smallest consumption band (0-73 MWh/annum) of between 0.8% and 3.5% with a fall in system charges for all other users. Users in the smallest consumption band consist mainly of domestic customers.

The pattern of impacts is consistent with an increase in the cost of the lower network pressure tiers compared to the higher network tiers. We have asked the GDNs why this is the case. They have explained that the cause is due to a combination of changes to the methodology for allocating costs to network tiers. They also noted the greater relative contribution of the iron mains replacement programme to GDN costs when compared with data currently used to set charges (ie pre-2001 data); iron main replacement mainly affects the lower network tiers.

Decision notice

In accordance with Standard Special Condition A5(5) of the Gas Transporter Licence, the Authority, hereby directs that modification proposal DNPC08: Review of Standard LDZ System Charges be made.

Rachel Fletcher (Partner, Distribution)

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