Extending the Notification Period of LDZ Charges

An RWE company

Background

- Currently Gas Distribution Networks are required to finalise and publish Gas Distribution tariffs **only 2 months** before they take effect.

- Customers typically will sign a **1, 2 or 3 year** gas contract with their shippers.

- Therefore at the point of contract signing, the shipper must forecast the next 1, 2 or 3 years of Gas Distribution tariffs for incorporation into the contract price.

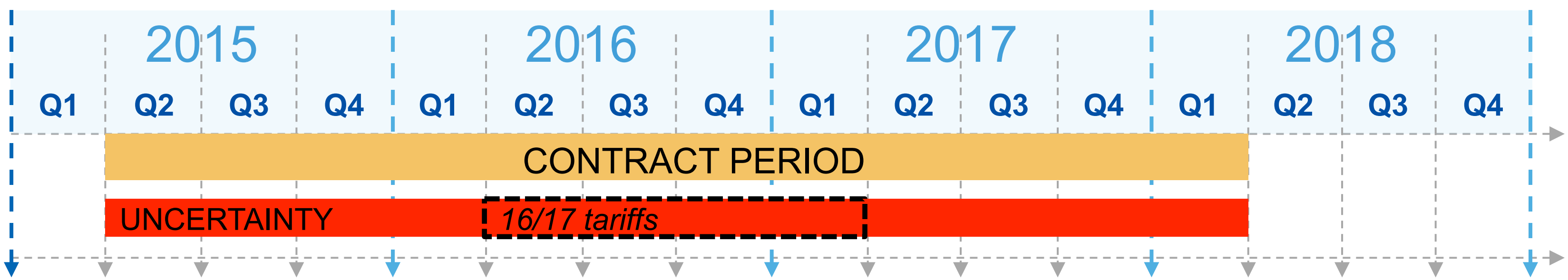
- There are typically 2 ways that Gas Distribution is treated in customer contracts;
  - **Pass through**
    - Customers on pass through contracts bear the risk around the charge volatility and pay the actual Gas Distribution charge once known.
  - **Non-pass through**
    - Many customers agree “fixed price” or “non-pass through” contracts where the Gas Distribution charge component is incorporated into the overall rates that the customer sees on their invoice.
    - **This will not be reconciled** and the shipper bears the risk of charge volatility.
    - Shippers may apply a **risk margin** to cover for uncertainty in future outturn Gas Distribution costs.
    - If a risk premium is applied, irrespective of whether shippers over or under forecast charges in the contract, the in-built risk premium means that the **cost stack is larger** than it would otherwise have been.

- The following slides demonstrate how an increased tariff notice period would impact the customer’s bill.

Worked example

As an example, we consider the following retrospective scenario;

- A customer in the East of England approaches their shipper in Jan-15 requiring a 3 year gas contract covering the period Apr-15 to Mar-18.
  - At this point Gas Distribution tariffs are only published up until 31st Mar-15.
  - From 1st Apr-15 onwards, the Gas Distribution tariffs are unknown.
  - Therefore a forecast of tariffs from 1st Apr-15 onwards is required in order to price the contract.



- As shown in the above, there is uncertainty from Apr-15 onwards, covering the whole duration of the contract period.

- Mod186 reports published quarterly by GDNs provide a best view forecast of future allowed revenues and price changes.
  - At the time of pricing this contract, the Oct-14 Mod186 report provides the best view available.

Worked example

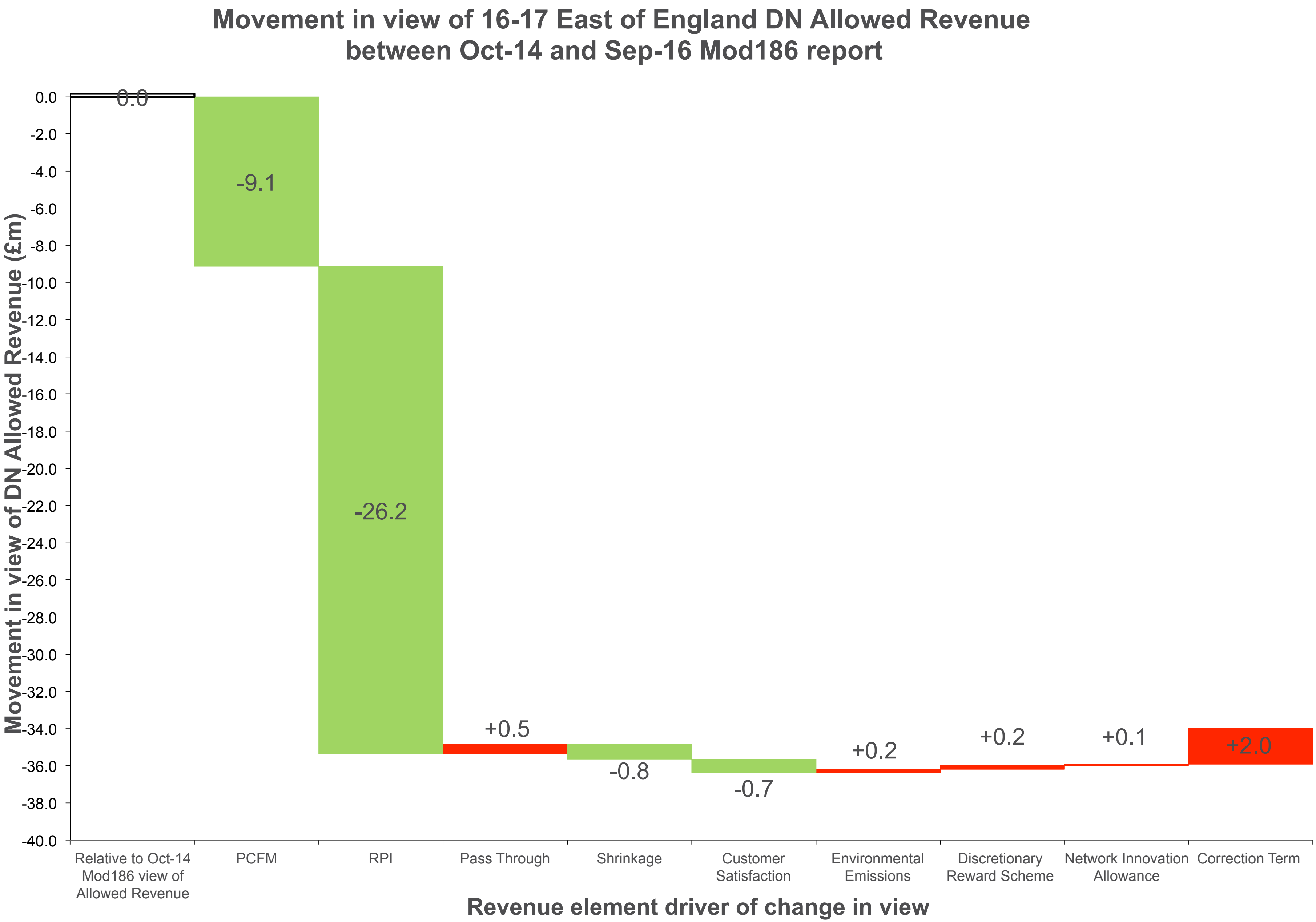
- The following shows the 16/17 price change forecast as per the Oct-14 Mod186 report, compared to the latest report view (Sep-16);

Description	Oct-14 view	Latest view	*Movement*
TABLE 4 - LDZ+Customer Charge Elements	**2016-17**	**2016-17**	***2016-17***
DN Allowed Revenue less ECN Allowed Revenue	**604.0**	**571.6**	***-32.5***
DN Collectable Revenue less ECN Allowed Revenue	**604.0**	**574.7**	***-29.3***
DN Under/Over Recovery Carried Forward	**-**	**3.1**	***3.1***
LDZ+Customer Arithmetical April Price Change (%)	**3.4%**	**-3.1%**	***-6.6%***
TABLE 5 - SOQ October Impact Assumption			
Annual October SOQ Assumption	-2.2%	1.7%	*3.8%*

- In Oct-14 the best view of 16/17 tariffs would have been a **3.4% price increase** on 15/16 tariffs.

- Therefore a shipper may price the contract based on this view. However, given previous variation from forecast to actual, a supplier may choose to apply an **additional risk premium.**

- However, in retrospect, 16/17 tariffs actually turned out to be a **-3.1% decrease** on 15/16.
  - This movement in view was driven by a combination of movement in Allowed Revenue and in SOQ.
    - Compared to the Oct-14 view, 16/17 Allowed Revenue ultimately decreased by **circa £30m**.
    - 16/17 SOQs were forecast to **reduce by 2.2%** as at Oct-14, but actually **increased by 1.7%**.

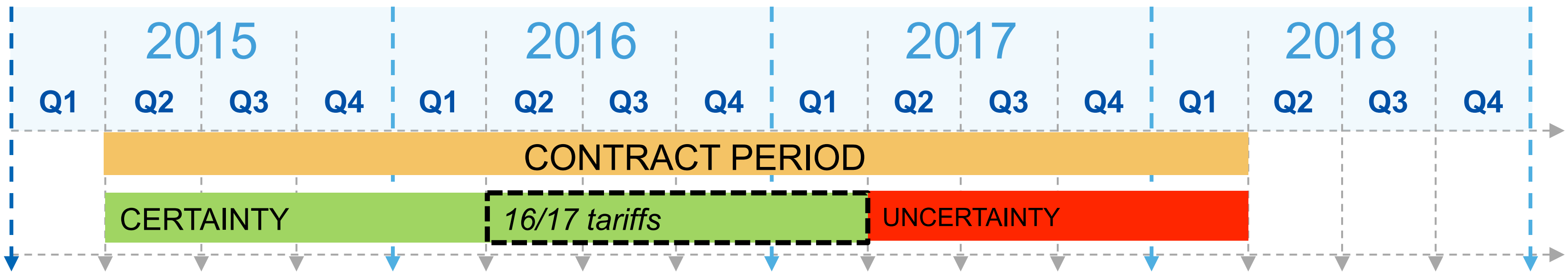

Movement in view of 16-17 East of England DN Allowed Revenue
between Oct-14 and Sep-16 Mod186 report
Movement in view of DN Allowed Revenue (£m)
0.0
-2.0
-4.0
-6.0
-8.0
-10.0
-12.0
-14.0
-16.0
-18.0
-20.0
-22.0
-24.0
-26.0
-28.0
-30.0
-32.0
-34.0
-36.0
-38.0
-40.0
0.0
-9.1
-26.2
+0.5
-0.8
-0.7
+0.2
+0.2
+0.1
+2.0
Relative to Oct-14 Mod186 view of Allowed Revenue
PCFM
RPI
Pass Through
Shrinkage
Customer Satisfaction
Environmental Emissions
Discretionary Reward Scheme
Network Innovation Allowance
Correction Term
Revenue element driver of change in view

Consequences

- Had a supplier based the contract price purely on the best view GDN forecast, the customer would have **over-paid by more than 5%** on the 16/17 portion of this contract.
- Had a risk premium been applied then this would have increased the price further.

Extending the Notification Period to 15 months

- With a 15 month notice period, we would instead have tariff certainty for the majority of the contract.
  - **No risk premia** would be required for this portion, and the customer would be charged exactly as per the final tariffs.



- This would then result in an over-recovery of circa £30m for the East of England network during 16/17.
  - This is because 16/17 final tariffs would have been set based on the "best view" of 16/17 revenue 15 months' ahead of time, which was circa £30m more than outturn allowance.

However the key difference is that this could then be passed back to customers, by deducting circa £30m from the Allowed Revenue of a later year (i.e. 18/19).

- Without the notice period, the customer may be over-paying with no mechanism for "refund".

Hypothetical reverse example – Increase in revenue

- Considering the reverse scenario, the view of revenue could arguably have **increased** instead compared to the view as at Oct-14.
- In Oct-14 the best view of 16/17 tariffs may have been a **-3.1% price decrease** on 15/16 tariffs.
- A shipper may price the contract based on this view, with an additional risk premium incorporated to cover the uncertainty.
  - However, in retrospect, 16/17 tariffs may have actually turned out to be a **3.4% price increase** on 15/16.
    - If the customer is on a pass through contract, they would have budgeted on the expected charge level and therefore would be hit with costs higher than budgeted with only 2 months' notice.
    - If the customer is on a non-pass through contract, the shipper takes the hit for the deficit.
      - Shippers may respond by increasing the risk premium for later years to account for the potential of such volatility, in order to avoid future loss.
      - The customer needlessly ends up with a higher bill through increased risk.

Extending the Notification Period to 15 months

- With a 15 month notice period, this scenario would have resulted in an under-recovery of circa £30m for the East of England network during 16/17, as tariffs would have been set before the increase was known.
- This £30m would then be **rolled forward** to be recovered from a later year instead (i.e. 18/19).

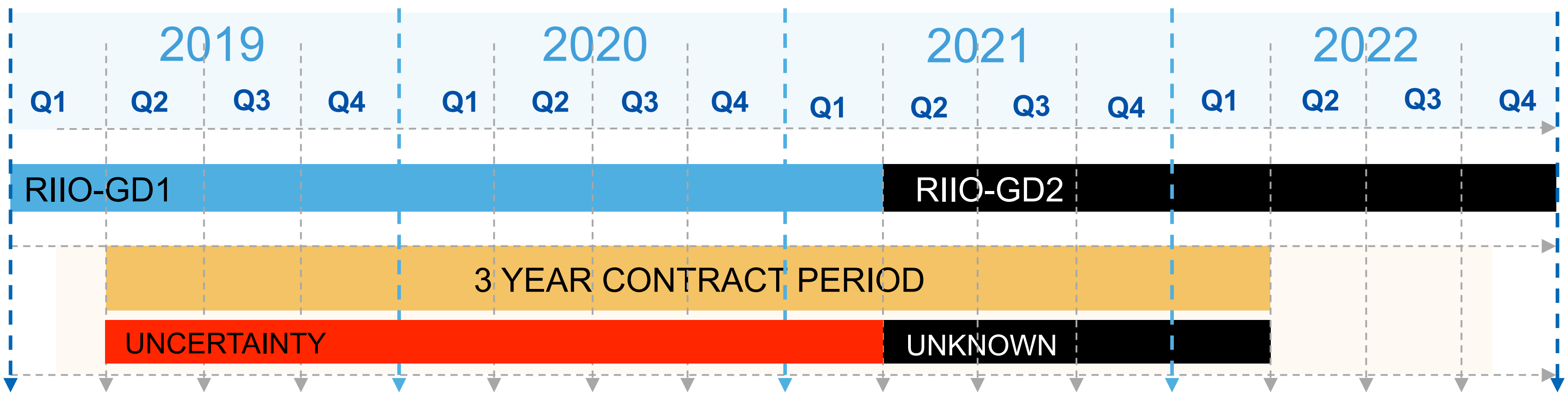
With 15 months' notice, the risk of this volatility is then manageable within customer contracts, as the majority do not span a period subject to correction – hence no risk premia required.

- This mechanism ensures that the **necessary revenue is still recovered**, but in a way that achieves **best value** for the customer, as risk premia is not required where tariffs are known.

Price Control crossover

- Without 15 months' notice, the situation will be exacerbated as we continue to approach the next Price Control RIIO-GD2 with **no indication of revenue allowances for this period**.

- Customers who require a gas contract before agreement of allowances are likely to be subject to **even greater levels of risk premia**, to cover the fact that tariffs for this period are completely unknown.
  - This results in customers over-paying simply to cover a **lack of transparency**.



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Summary

- Having 15 months' notice of tariffs would provide shippers and consumers with **greater and earlier certainty** of future Gas Distribution charges that they will face.

- The Gas Distribution risk premium for non-pass through contracts covering the period where the tariffs are published would be removed, removing the unnecessary cost of risk from customer bills.
  - This would result in **improved competition** between suppliers by reducing the uncertainty around the Gas Distribution tariffs.

- Pass through customers will also benefit from the **increased budget certainty**.

- An increased notice period may lead to a larger under/over recovery to be rolled forward to later years.
  - However customers will benefit as their contract is **unlikely to span a period that covers a tariff year subject to a potentially significant unknown true-up**.

In parallel on the electricity side, the DCUSA change DCP178 was approved by Ofgem last year, meaning that final Distribution Use of System (DUoS) charges are now published 15 months ahead of time (previously just 40 days' notice).