UNC Workgroup 0368
- Smoothing of Distribution Charge Variation -
Minutes
Wednesday 13 April 2011
ENA, 52 Horseferry Road, London SW1P 2AF

Attendees

Tim Davis (Chair)	TD	Joint Office
Lorna Dupont (Secretary)	LD	Joint Office
Bernard Kellas	BK	SSE
Bill Bullen	BB	Utilita
Chris Warner	CW	National Grid Distribution
Denis Aitchison	DA	Scotia Gas Networks
Gareth Evans	GE	Waters Wye Associates
Jo Parker	JP	Scotia Gas Networks
John Edwards	JE	Wales & West Utilities
Malcolm Piper	MP	EDF Energy
Patrick Taylor	PT	CEPA
Rachel Fowler	RF	RWE npower
Richard Dutton	RD	Total Gas & Power
Rochelle Hudson	RH	British Gas
Will Guest	WG	Northern Gas Networks

1.0 Introduction

TD welcomed all to the meeting.

2.0 Outline of Modification

RD introduced the modification and it aims, emphasising that price volatility is a significant issue for Shippers, with twice yearly changes exposing parties to increased financial risk, creating administrative burdens and associated costs every 6 months, and difficulties with customer relationships.

The proposed solution was briefly outlined.

3.0 Consider Terms of Reference

No comments were provided.

4.0 Initial Discussion

Volatility of Network Charges

Centrica had commissioned Cambridge Economic Policy Associates (CEPA) to review charging volatility and uncertainty issues in the context of RIIO-GD1 and RIIO-T1. PT (CEPA consultant) gave a presentation outlining the findings, including the significance of the effects of charging volatility on both Shippers and consumers, and what CEPA considered to be potential 'top down' mechanisms (not mutually exclusive) available for consideration in respect of managing these issues and risks going forward. A discussion ensued.

TD asked for a definition of volatility, and questioned whether it was stability or predictable prices that were of concern. Different definitions were provided by RH (total charge for that customer and how it had changed over 6 months) and RD (forecast revenue of X and anything that varies from that). RD believed that DNPC08 had introduced more volatility. DA disagreed – it had introduced a change which is not, in itself, volatility but a restructuring. RD responded that volatility exists (eg readjustment of prices; 95:5 introduction; other changes on the way). The volatility being seen was not acceptable.

DA explained that all the changes were reflecting the DNs' Licence requirement that charges should be cost-reflective on a network by network basis. Costs change over time and charging methodologies are kept under review. He would disagree that it indicated volatility; advance warning was given to the community and these changes were not unpredictable.

Observing that Shippers required stability and predictability, GE conceded that changes did happen and tolerance bands could be built in in some cases, but large swings cause problems. JE referred to licence obligations impacting allowed revenue and its collection. GE appreciated that rules had been set for the DNs but believed that changes to rules could be made to ensure fairness to all parties. RD pointed out that as a DN customer he was experiencing significant problems and believed that the DNs should be discussing the position with Ofgem. RD disagreed with DA's views and reiterated that it was extremely difficult for Shippers to apply accurate predictions of network charges. Consequently there was uncertainty around the setting of charges for customers.

DA pointed out that DNs suffer from unpredictability of allowed revenue and would welcome change that would offer more stability. What really causes K is the unpredictability of allowed revenue, and stability would benefit all.

Referring to the mechanisms indicated in the CEPA presentation, PT suggested that these types of mechanisms might allow management of allowed revenues. TD pointed out that prices can still be restructured from year to year within the same revenue, and hence there could still be concern regarding volatility.

GE observed that all risk eventually percolates through to the Shipper who has to pick up step changes in charges. An acceptable level of risk needs to be established, as well as an acceptable regime for DNs to recover their costs. DA responded that the more that could be done to improve the predictability of allowed revenue the less adjustment would be required later. Reducing high levels of K in the first place would help. GE pointed out that when the DNs' predictions were not accurate, Shippers have to pick up the various risks of trying to accommodate the changes. JE added that he would prefer more fixed parameters.

Historical T & D Charge Volatility

RH (British Gas) gave a brief presentation illustrating the perceived volatility of T & D charges based on the example of a domestic customer (AQ of 18,500kWh applied to all regions; full year T & D (Transmission and Distribution) price and load factor applied to 12 months; NTS capacity rate averaged for each LDZ – not weighted).

DA commented that the inflexibility of the regime forces swings. RH's graphs provided a measure of the volatility and TD added that the illustration demonstrated the scale of the Shippers' perceived problems.

The purchase of shrinkage was briefly discussed. Allowed revenues were based on Day Ahead price and a natural hedging strategy was to do likewise, which could create volatility. It was suggested that a change could be made to the Licence through the

Price Control process to give more stability to the shrinkage element. The change to 95:5 appeared to have helped to smooth prices a little, but there was still cause for concern. PT commented that retail customer behaviour indicated that they value fixed price contracts when there is a risk of prices rising by large degrees.

GE commented that the risk of volatility means that Shippers are more likely to pitch prices higher rather than lower, as currently all of the risk appears to sit with the Shipper, and the cost of working capital is arguably higher for most Shippers than DNs. The composition and impact of the modification was discussed. RD asked if elements other than K should also be added in? DA observed that K was a minor element (it had reduced since the introduction of 95:5) and considered that it was the DN incentives that had more of an effect on charge levels - smoothing K would have a relatively small impact. JE pointed out that, for Wales & West Utilities, K was 1% and other factors contributed a greater percentage: SOQ reductions impacting capacity income; inflation; and incentive variations. For Northern Gas Networks, WG reported that the biggest issues were the AQ reductions and the RPI factor. DA also recognised these elements; for Southern Network K was 5% of 18.9%, but for Scotland Network it was a very small element. He believed that K was only part of the problem.

RD pointed out that the change to 95:5 did not help Shippers as much as had been anticipated or expected. DA recognised that while it had allowed more accuracy in some areas, SOQ changes had become a more important element. RD believed that the SOQ changes required better management. DA responded that the DNs had been liaising with Xoserve, and explained the timescales in the UNC were a constraint. RD questioned again: How can volatility in the DNs' pricing be reduced?

DA observed that changing in April means charge setting on 01 February, ie before the end of the year. By contrast, setting charges for October would mean there is a much better idea of what the allowed revenue is in the year that you are setting charges for (charges fixed on 01 August). Earlier SOQ information from Xoserve may help. It was a Licence change that drove the move to setting charges in April, but with the possibility of changing charges twice a year. There could be advantages in going back to one change per year, in October.

GE commented that the costs associated with the price changes cost the industry far more than the DNs carrying the debt for 6 months. RD added that Transmission changed its prices in February, so Shippers were subjected to, and must accommodate, price changes three times a year. It was suggested that one price adjustment a year, to which all DNs adhered, would be more appropriate.

RD questioned what should be included in the smearing of any ability to recover cost variations, as proposed in the modification – K, cost pass through movement, incentives movement, shrinkage? JE commented that some of these elements were relatively small. DA believed they would need to be set after inflation, and was concerned that if you start smearing everything, after a couple of years you start to accumulate and could find there is no difference (movements continually in one direction). K could be expected to be a series of pluses and minuses.

JE suggested focussing on total allowed revenue. Restricting the parameters was potentially a better way forward so that parties would know any change would never be more/less than a fixed percentage, ie a narrower variation. TD added that the modification was focusing on revenue and not charges; there could still be unpredictability regarding charges and this would not be eliminated unless charges were capped, such as through the mechanism suggested by JE.

GE clarified that the DNs keeping any over recovery for a year or two would be better for the Shippers in terms of smoothing away any volatility. RD added that, as long as the Shippers had factored it in, this was fine.

TD concluded that the DNs appeared to prefer a top down approach that used a model based on maximum percentage change. Another option might be a model based on revenue – what would this look like and what would it include? Having briefly discussed how this might proceed, the following actions were agreed:

Action WG0368/0401: Consider and develop a model based on percentages.

Action WG0368/0402: Look more closely at and develop a model based on revenue.

Action WG0368/0403: Provide a presentation on the Licence Conditions and the Price Control arrangements, and the ability to under or over recover.

Action WG0368/0404: Model K and replicate for all networks, and include 'smoothing'.

Action WG0368/0405: Consider how shrinkage alone affects volatility and establish how much of allowed revenue is down to shrinkage.

It was appreciated that any change to the UNC might potentially also impact on the Licence Conditions, and it was pointed out that the DNs are not allowed to set charges to knowingly over recover. It was therefore important that Ofgem were fully aware of the implications of the modification.

PT confirmed that the modification contained much of what had been thought about when compiling the CEPA report on the volatility of network charges.

Next Steps

Consideration will be given to all the options put forward and the proposer will then review the modification as appropriate.

RH indicated that British Gas might put forward an alternative modification.

TD encouraged the early submission of any alternatives in order that the Workgroup have sufficient time to consider differing approaches.

5.0 Diary Planning for Workgroup

The next meeting is scheduled for Monday 16 May 2011, at ENA, 52 Horseferry Road, London SW1.

Action Log

Action Ref	Meeting Date	Minute Ref	Action	Owner	Status Update
WG0368/0401	13/04/11	4.	Consider and develop a model based on percentages.	All DNs	By 16 May 2011
WG0368/0402	13/04/11	4.	Look more closely at and develop a model based on revenue.	Total (RD/GE)	By 16 May 2011
WG0368/0403	13/04/11	4.	Provide a presentation on the Licence Conditions and the Price Control arrangements, and the ability to under or over recover.	Scotia Gas Networks (DA)	By 16 May 2011
WG0368/0404	13/04/11	4.	Model K and replicate for all networks, and include 'smoothing'.	Northern Gas Networks and Wales & West Utilities (WG and JE)	By 16 May 2011
WG0368/0405	13/04/11	4.	Consider how shrinkage alone affects volatility and establish how much of allowed revenue is down to shrinkage.	All DNs	By 16 May 2011