Modification proposal:	**Uniform Network Code ('UNC') Modification UNC382 Reducing the capacity element of LDZ system charges for smaller supply points (SSPs)**		
Decision:	The Authority[1] has decided to reject this proposal		
Target audience:	The UNC Panel, Parties to the UNC and other interested parties		
Date of publication:	24 November 2011	Implementation Date:	n/a

Background to the proposed modification

Gas Distribution Networks ('GDNs') are obliged to keep their charging methodology under review to ensure that the objectives of the charging methodology are being achieved further to Standard Special Condition (SSC) A5 (2A)(a) of the gas transporters' licence ('the Licence').

Distribution Use of System (UoS) charges recover costs that relate to the provision, maintenance and operation of the distribution network. Revenue is collected from separate capacity and commodity charging functions. Capacity charges are collected on the basis of peak day capacity as measured by Supply Offtake Quantity (SOQ)[2] whilst commodity charges are collected on the basis of actual annual consumption. At present the separate charging functions are set such that total revenue is split 95/5 between capacity and commodity.

In the recent past, we and the industry, have undertaken a significant amount of work, including an impact assessment (2007 IA) to establish the appropriate split between capacity and commodity charges, resulting in the current arrangements. That IA presented analysis that considered modification proposal DNPC03[3] in light of the charging methodology objectives set out in the GDNs' Licence. We therefore expect any subsequent modification of the current split between capacity and commodity charges to revisit the previous analysis in order to justify how the proposed modification better achieves these objectives.

On 13 December 2007, Ofgem decided not to veto DNPC03 which was a proposal to revise the split in revenue recovery between capacity and commodity charges from 50/50 to 95/5 respectively. The change in the split of revenue recovery through system charges was based on analysis that showed that very little of the GDNs' costs were driven by gas throughput (commodity). The analysis identified that shrinkage and odorant were the only costs related to throughput and contributed between 4 and 6 per cent of total GDN costs. Shrinkage costs were related to throughput because the price control mechanism at that time set target shrinkage volumes as a proportion of throughput.

GDNs also argued that reducing the proportion of commodity based charges would reduce the volatility of overall system charges because there would be less need to change charges to account for differences between actual and forecast revenue. The

[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] Which is the maximum daily consumption for a supply point
[3] Our decision letter for the modification proposal DNPC03 can be found on our website here

DNPC03 proposal argued that as most of the costs were fixed[4] it was more appropriate that they were recovered through the fixed capacity charge. It was argued that this would increase the predictability of the amounts charged to shippers for transportation and would facilitate competition among shippers and suppliers.

We decided not to veto DNPC03 largely on the basis that it would lead to an improvement in the predictability of charges that would facilitate competition between shippers and suppliers. The cost information provided by the GDNs, as part of the DNPC03 process, indicated that the majority of the costs related to the provision of capacity on the network and only a small proportion related to system throughput. However the GDNs failed to prove that this meant that 95% of costs were related to system capacity. Consequently in our decision we stated that the proposal to move to a 95/5 capacity/commodity split could not be fully justified on the basis of cost reflectivity.

Since DNPC03 was approved, the basis for setting price control shrinkage targets changed as part of the final proposals for the current Gas Distribution Price Control Review (GDPCR).[5] The baselines for GDPCR were set as a fixed volume that does not vary with throughput.[6] This change reflected the fact that levels of shrinkage from GDN networks depend more on network characteristics, such as surface area and type of pipe, and very little on gas throughput.

In January 2011 we vetoed DNPC07 which, in light of the GDPCR approach to shrinkage, intended to change the split between capacity and commodity charges from 95/5 to 100/0 respectively. The GDN's rationale for this change was that the majority of costs attributed to the commodity component relate to shrinkage, which they argued no longer varies with throughput of gas on the network. We agreed that the changes introduced in GDPCR meant that costs associated with shrinkage were no longer linked to throughput, however the proposal did not demonstrate with sufficient robustness that almost all the GDN costs varied with capacity. We therefore vetoed this proposal as a compelling case had not been made to justify such a significant change to the GDNs' charging methodology and we could not conclude that the proposal would improve cost reflectivity. Moreover, implementing DNPC07 would have meant a cash flow benefit for the GDNs and conversely a cash flow and credit cost for shippers.

We expect any subsequent modification, particularly one that could result in a significant change to the current arrangements, to give further consideration to these aspects and provide a robust justification for overturning our previous decision.

The modification proposal

On 6 May 2011 Utilita raised Modification Proposal UNC382 "Reducing the capacity element of LDZ system charges for SSPs". The modification proposes to change the split between capacity and commodity charges, for Smaller Supply Points (SSPs[7]), from 95/5 to 50/50.

Utilita's rationale for this change is that at present Local Distribution Zone (LDZ) charging arrangements are primarily based on capacity bookings, which are largely fixed throughout the year. They argue that supplier revenue however is driven by the amount of gas consumed, which is higher in winter than in summer. This creates a mismatch

[4] That is the costs associated with providing the overall capacity of the network, together with overhead functions such as IT, HR, Finance etc.

[5] Final Proposals were published on 3 December 2007. The current GDPCR was set to last between 2008 and 2013.

[6] Expected leakage is determined by running an agreed technical model, populated with GDN specific asset data.

[7] SSPs are sites with Annual Quantity below 73,200 kWh

between supplier costs and revenues, which potentially makes the sale of gas a loss making activity during the summer months.

Utilita asserts that while this may not create particular difficulties for suppliers with large, diverse portfolios, or those with a low cost of capital, a significant cash flow issue is created for other small suppliers.

UNC Modification Panel recommendation

The UNC Modification Panel considered UNC382 on 20 October 2011 and determined by a majority of 9 votes to 1 to recommend that it be rejected.

The Authority's decision

The Authority has considered the issues raised by the modification proposal and the Final Modification Report (FMR) dated 21 October 2011. 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[8].

The Authority has concluded that the implementation of UNC382 will not better facilitate the achievement of the relevant methodology objectives and therefore should not be implemented.

Reasons for the Authority's decision

The impact of the proposal is expected to be significant given the change in the proportion of costs that are currently recovered from the commodity charge, with those engaged in the shipping, transportation and supply of gas conveyed through pipes being particularly affected. For these reasons we require substantial and robust analysis to justify such a marked change to the current arrangements.

We have assessed the modification against the relevant methodology objectives (a) and (c) as set out under SSC A5 (5) of the Licence as follows:

1- Cost reflectivity:

Relevant methodology objective (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*

UNC382 proposes to change the split between capacity and commodity charges, for SSPs, from 95/5 to 50/50. However UNC382 has not provided any up to date, detailed quantitative analysis to justify how 50% of the costs incurred by the licensee could be attributed to system throughput. In the absence of a more thorough analysis we are not able to determine whether the move to 50/50 is more cost reflective. We cannot therefore conclude that the proposal will better facilitate the achievement of objective (a).

2- Facilitating effective competition

Relevant methodology objective (c) *- That, so far as is consistent with (a) and (b), compliance with the charging methodology facilitates effective competition between gas shippers and between gas suppliers*

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

UNC panel members were divided on whether implementation would better facilitate competition. Although the move to 95/5 split was meant to increase competition by allowing suppliers to predict charges with confidence, some members did not feel that significant benefit had accrued in practice, with prices remaining difficult to predict. By contrast, other members noted that implementing UNC382 would better align costs and revenues for existing small businesses and potential new entrants, whose cash flows might be negatively affected during the summer months and would therefore impair their ability to compete.

We recognise that such cash flow impacts are important for individual businesses. We have not been provided however with any quantitative evidence, such as: customer payment plans (proportion of customers who pay by monthly direct debit on fixed and variable basis); suppliers' cost data (direct capacity and commodity costs as well as indirect costs); and data on the misalignment between suppliers' costs and revenues in summer and potential savings. In the absence of this type of evidence it has not been demonstrated how the current arrangements create a barrier to entry or how this proposal will better promote competition between gas shippers and gas suppliers.

In assessing this proposal we undertook our own analysis on the payment terms provided by other small suppliers. This analysis highlighted that for many suppliers most, if not all, of their SSP customers are on fixed monthly direct debit payment schemes. Although we are sympathetic to the concerns regarding cash flow that the proposer has raised, if we were to approve this modification we would redistribute the cash flow impacts from one type of supplier (whose revenue from customers is tied to the profile of energy usage), to other suppliers with a flat revenue profile who may be of comparable size.

We also note that this modification will not allow suppliers to SSPs to be able to predict transportation charges with certainty and plan accordingly. Conversely by linking more of the charge to throughput UNC382 is likely to result in increased volatility than the current arrangements. As a result, removing potential barriers to entry for new suppliers is unlikely to be achieved through UNC382.

Therefore we cannot conclude that the proposal will better facilitate the achievement of objective (c).

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Signed on behalf of the Authority and authorised for that purpose