

Stage 02: Workgroup Report

0382:

Reducing the capacity element of LDZ system charges for SSPs

What stage is this document in the process?

01 Proposal

02 Workgroup Report

03 Draft Modification Report

04 Final Modification Report

LDZ system charges are weighted 95:5 between capacity and commodity. This modification seeks to amend this to 50:50 for SSPs.



The Workgroup recommends that this modification should now proceed to Consultation



High Impact: Smaller Shippers

Cashflow impact, aligning costs and revenues



Medium Impact:

Insert name(s) of impact



Low Impact: Transporters

Cashflow impact

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Workgroup Report

25 July 2011

Version 1.0

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About this document:

The purpose of this report is make a recommendation to the Panel, to be held on 18 August 2011, on whether Modification 0382 is sufficiently developed to proceed to Consultation and to submit any further recommendations in respect of the definition and assessment of this modification.



3 **Any questions?**

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1 Summary

Is this a Self-Governance Modification

Implementation would have a significant impact on smaller domestic suppliers in particular, and so does not meet the criteria for a self-governance modification.

Why Change?

The present LDZ charging arrangement is primarily based on capacity bookings, which are largely fixed throughout the year. Supplier revenue is driven by the amount of gas consumed, which is higher in winter than in summer. This creates a mismatch between supplier costs and revenues, and potentially makes the sale of gas a loss making activity during the summer months. This creates cashflow issues and is a barrier to entry.

Solution

It is proposed that, for Smaller Supply Points, the capacity element of the LDZ System charges be targeted to recover 50% rather than 95%, and the commodity element of the LDZ System charges is targeted to recover 50% rather than 5%, of the revenue from the LDZ system charges.

Impacts & Costs

Since the Transporters introduced a move to charging based on a 95:5 rather than 50:50, no significant systems impacts are anticipated if this is reversed. The Transporters funded all systems costs associated with the move to 95:5 and would similarly be expected to fund any costs which arise from a return to 50:50.

Implementation

The Proposer wishes to see implementation at the earliest possible opportunity.

Workgroup attendees suggested the timetable for implementing this modification should be consistent with the timing of changes to transportation charges but also provide a long lead time to allow the changed basis of charging to be reflected in the prices offered to customers.

The Case for Change

Implementation will facilitate competition by helping to ensure revenue and costs are more closely aligned, reducing the possibility of gas being supplied at a loss during the summer months and addressing a cashflow issue which can act as a barrier to entry and a barrier to business development for smaller suppliers in particular.

Recommendations

The Workgroup considers that the Modification is sufficiently developed and should now proceed to Consultation.

2 Why Change?

The present LDZ charging arrangement is primarily based on capacity bookings, which are largely fixed throughout the year. In the case of domestic suppliers, transportation charges are based on AQs which are set for a year and do not always reflect the true level of capacity usage, especially when energy efficiency measures are installed, reducing consumption without any immediate benefit through reduced capacity charges. By contrast, Supplier revenue is driven by the amount of gas consumed, which is higher in winter than in summer, and is reduced as a result of energy efficiency initiatives.

The mismatch between the profiles of supplier revenue and transportation charges potentially makes the sale of gas a loss making activity during the summer months. While this may not create particular difficulties for suppliers with large, diverse portfolios, or those with a low cost of capital, a significant cashflow issue is created for some suppliers. The issue is particularly acute for smaller suppliers with a primarily domestic customer base, and especially those that actively promote and encourage adoption of energy efficiency measures. The mismatch therefore creates an inappropriate barrier to market entry and business development, and change is needed to encourage greater competition within the domestic market.

3 Solution

It is proposed that, for Smaller Supply Points, the DN Transportation Charging methodology, as set out in Section Y of the UNC, is modified such that the capacity element of the LDZ System charges be targeted to recover 50% rather than 95%, and the commodity element of the LDZ System charges is targeted to recover 50% rather than 5%, of the revenue from the LDZ system charges.

4 Relevant Objectives

Implementation will impact the achievement of **Relevant Methodology Objective a and c.**

Proposer's view of the benefits against the Code Relevant Methodology Objectives

Description of Relevant Objective	Identified impact
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;	Yes
aa) that, in so far as prices in respect of transportation arrangements are established by auction, either: <ul style="list-style-type: none"> (i) no reserve price is applied, or (ii) that reserve price is set at a level - <ul style="list-style-type: none"> (I) best calculated to promote efficiency and avoid undue preference in the supply of transportation services; and (II) best calculated to promote competition between gas suppliers and between gas shippers; 	
b) that, so far as is consistent with sub-paragraph (a), the charging methodology properly takes account of developments in the transportation business;	
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; and	Yes
d) that the charging methodology reflects any alternative arrangements put in place in accordance with a determination made by the Secretary of State under paragraph 2A(a) of Standard Special Condition A27 (Disposal of Assets).	

The Workgroup recognised that a move to 95:5 from 50:50 had been introduced following an Ofgem Impact Assessment. The two main justifications for not vetoing the change were:

Cost Reflectivity - *The GDNs considered that the cost information showed the majority of costs relate, either directly or indirectly, to the provision of capacity on the network and that only a small proportion relate to system throughput.*

Ofgem accepted that approximately 95% of Use Of System costs are unaffected by throughput but considered that some of the indirect costs were effectively fixed, varying with neither capacity nor throughput. However, Ofgem considered that the fixed costs should not be recovered on a commodity basis.

Improved Charge Stability and Predictability - *The GDNs considered that the change would better align the effect of system throughput variations on allowed and collected revenue so reducing instability in charges and improving*

the predictability of charge levels.

Ofgem agreed that the change should almost entirely remove system throughput as a contributory factor to K and hence as a source of variability in charge levels and that this should provide greater stability in charge levels.

Some Workgroup participants, including all the transporters, continued to support this view and so believed a move back to 50:50 would not facilitate achievement of the relevant objectives. While a number of Workgroup attendees were relatively neutral regarding the proposed change, some believed that some factors had not been given sufficient weight previously and so a move to 50:50 is justified. They argued that cost reflectivity may be improved by implementation of Modification 0382 since capacity related costs are driven by peak demands, which arise in the winter. It is therefore more cost reflective for the collection of charges to be focussed on the winter months, when peak demand is more likely to arise.

Competition would also be facilitated by more closely aligning the profile of revenues and costs. This would remove the barrier to entry that smaller suppliers, in particular, face at present because of the mismatch between costs and revenues. This creates a cashflow problem, with cashflow being widely recognised as a major issue for smaller organisations and new entrants. The present arrangements can make supply to domestic premises loss making in the summer months, which is a strong deterrent to entry and customer acquisition during the summer months. Creating more appropriate incentives to acquire customers, to encourage energy efficiency, and to remove barriers to entry would facilitate the development of effective competition.

The modification does not conflict with paragraphs 2, 2A and 3 of Standard Special Condition A4 of the Transporter's Licence since any change in charges would be applied based on the methodology prevailing at the time.

5 Impacts and Costs

Consideration of Wider Industry Impacts

Implementation would not be expected to have an adverse impact on wider industry developments.

Costs

Indicative industry costs – User Pays	
Classification of the proposal as User Pays or not and justification for classification	
Transporters would need to ensure invoice calculations reflect their obligations. This is a Transporter responsibility and therefore this is not a User Pays modification. The basis for funding should be the same as that when Transporters introduced a 95:5 capacity:commodity split, with the transporters funding any costs faced by themselves.	
Identification of Users, proposed split of the recovery between Gas Transporters and Users for User Pays costs and justification	
Not applicable	
Proposed charge(s) for application of Users Pays charges to Shippers	
Not applicable	
Proposed charge for inclusion in ACS – to be completed upon receipt of cost estimate from xoserve	
Not applicable	

Impacts

Impact on Transporters' Systems and Process	
Transporters' System/Process	Potential impact
UK Link	• None
Operational Processes	• None
User Pays implications	• None

Impact on Users	
Area of Users' business	Potential impact
Administrative and operational	• None
Development, capital and operating costs	• Costs re-profiled
Contractual risks	• None

Where can I find details of the UNC Standards of Service?

In the Revised FMR for Transco's Network Code Modification

0565 Transco Proposal for Revision of Network Code Standards of Service at the following location:
<http://www.gasgovernance.co.uk/sites/default/files/0565.zip>

Impact on Users	
Legislative, regulatory and contractual obligations and relationships	<ul style="list-style-type: none"> None

Impact on Transporters	
Area of Transporters' business	Potential impact
System operation	<ul style="list-style-type: none"> None
Development, capital and operating costs	<ul style="list-style-type: none"> None anticipated
Recovery of costs	<ul style="list-style-type: none"> Re-profiling would occur
Price regulation	<ul style="list-style-type: none"> The Charging methodology would be modified
Contractual risks	<ul style="list-style-type: none"> None
Legislative, regulatory and contractual obligations and relationships	<ul style="list-style-type: none"> None
Standards of service	<ul style="list-style-type: none"> None

Impact on Code Administration	
Area of Code Administration	Potential impact
Modification Rules	<ul style="list-style-type: none"> None
UNC Committees	<ul style="list-style-type: none"> None
General administration	<ul style="list-style-type: none"> None

Impact on Code	
Code section	Potential impact
Section Y	Replace "95" and "5" with 50

Impact on UNC Related Documents and Other Referenced Documents	
Related Document	Potential impact
Network Entry Agreement (TPD I1.3)	None
Network Exit Agreement (Including Connected System Exit Points) (TPD J1.5.4)	None
Storage Connection Agreement (TPD R1.3.1)	None

Impact on UNC Related Documents and Other Referenced Documents	
UK Link Manual (TPD U1.4)	None
Network Code Operations Reporting Manual (TPD V12)	None
Network Code Validation Rules (TPD V12)	None
ECQ Methodology (TPD V12)	None
Measurement Error Notification Guidelines (TPD V12)	None
Energy Balancing Credit Rules (TPD X2.1)	None
Uniform Network Code Standards of Service (Various)	None

Impact on Core Industry Documents and other documents	
Document	Potential impact
Safety Case or other document under Gas Safety (Management) Regulations	None
Gas Transporter Licence	None

Other Impacts	
Item impacted	Potential impact
Security of Supply	None
Operation of the Total System	None
Industry fragmentation	None
Terminal operators, consumers, connected system operators, suppliers, producers and other non code parties	None

6 Implementation

While the Proposer was looking for immediate implementation, other Workgroup attendees supported the following:

On 1 April 2013 if an Ofgem decision is received on or before 1 February 2012;
On 1 April 2014 if an Ofgem decision is received on or before 1 February 2013; or
Within 18 months following receipt if an Ofgem decision is received after 1 February 2013.

These dates are proposed to allow time for the DNs to implement the change and give Shippers sufficient notice of charges ahead of 1 April, the normal date for changes to Transportation Changes in accordance with the DN Licences, such that the revised structure can be reflected in prices offered to customers.

7 The Case for Change

None in addition to that identified above.

8 Legal Text

Draft Text Provided by National Grid Distribution:

UNIFORM NETWORK CODE – TRANSPORTATION PRINCIPAL DOCUMENT

SECTION Y – CHARGING METHODOLOGIES

PART B – DN TRANSPORTATION CHARGING METHODOLOGY

The Gas Distribution Transportation Charging Methodology

Amend section 3 of UNC TPD Section Y, Part B – DN Transportation Charging Methodology as follows:

3. Split of revenue recovery between LDZ System Capacity and Commodity Charges

In respect of Larger Supply Points the capacity element of the LDZ System charges is targeted to recover 95%, and the commodity element of the LDZ System charges is targeted to recover 5%, of the revenue from the LDZ system charges.

In respect of Smaller Supply Points the capacity element of the LDZ System charges is targeted to recover 50%, and the commodity element of the LDZ System charges is targeted to recover 50%, of the revenue from the LDZ system charges.

In respect of Larger Supply Points the above apportionment is based on an assessment of the extent to which LDZ System associated costs are related to throughput or to system capacity.

The apportionments described above apply to all the Distribution Networks.

9 Recommendation

The Workgroup invites the Panel to:

- AGREE that Modification 0382 be submitted for consultation.