



*Bringing choice and
value to customers*

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21 January 2002

Dear Tim,

Transco pricing consultations PC68 and PC71

This letter confirms Ofgem's intention not to veto the charging methodology modifications proposed by Transco in PC68 and PC71. The reasoning behind these decisions is set out below.

PC68

In November 2001 Transco consulted on four changes to its LDZ charging methodology:

- ◆ to subdivide the Low Pressure System into six sub-tiers for the purposes of charge calculation;
- ◆ to calculate the connection probabilities used within the methodology weighted by the AQ of the connections within each of the consumption bands;
- ◆ to adopt three stage power functions for the LDZ transportation charges for directly connected supply points and to CSEPs; and
- ◆ to use charging functions based on a power of the peak demand rather than on a log of the peak demand.

A number of points were raised by respondents in respect of the specific consultation issues and more generally over Transco's approach to consultation. On the basis of the consultation and Transco's response to points raised by respondents Ofgem has decided not to veto the modifications set out in PC68. The main points raised by respondents are addressed in turn below.

Low Pressure System sub-tiers

Ofgem encouraged Transco to review the use of pressure tiers by different sized customers and supports the move from four to six sub-tiers, as this should allow charges to be apportioned across customers in a more cost reflective manner.

Use of AQ weighted connection probabilities

Although the use of AQ weighting has a limited impact on the analysis, Ofgem supports this development as it should contribute towards cost reflective charging.

Use of a three stage power function

Ofgem asked Transco to consider the fit of its charging function, and whether alternative functions would be more appropriate. Transco reviewed the existing log function and as an alternative proposed a three stage power function. This function will apply to LDZ and CSEP charges. Ofgem supports these developments as the new function appears to more closely fit the data. The new function has increased the proportion of costs borne by small (100,000 to 1 million kWh) industrial or commercial users and very large users (1 billion kWh), although the function underestimates the contribution of these two categories to overall LDZ costs when compared to the underlying data.

A number of issues were raised in the application of the three stage power function to CSEP charges. These included the sensitivity of the function to data changes for small and large CSEPs and the need to improve the quality of CSEP connection data. Some respondents raised concerns that the econometric analysis was not sufficiently robust and assumptions within the function had not been adequately tested. There was a general criticism that, with the technical nature of the proposed changes, sufficient data had not initially been made available in the consultation.

In response to criticisms Transco adjusted the impact of the function on small and large CSEPs, generating charges that are equivalent or lower than the LDZ charges to end-users, and improved the CSEP connection data. Transco has also investigated the impact of more consumption bands on the allocation of costs, finding no significant variation between 17 and 11 consumption bands. The effect of these changes is to bring the CSEP charge at or below the LDZ direct charge.

Additional analysis by Transco on the proportion of costs that CSEPs contribute to overall costs is desirable. In particular, this applies to those CSEPs with very high annual demand. Although Transco's analysis has indicated that CSEPs use less LDZ assets than equivalent sized direct connections, continuing concerns have been expressed as to the balance of revenue recovered from CSEPs compared to LDZ connections. Ofgem suggests that further analysis is undertaken to ensure equitable treatment of CSEPs and direct connections.

It will be important that Transco provides adequate information in the future in order to give customers comfort that charging structures are appropriate. If this process reveals the need for further changes in charging arrangements it will be necessary for Transco to bring these forward in due course.

Transco did not review the capacity-commodity split of charges. In March 2000 Ofgem considered the benefit of Transco undertaking a review of the capacity-commodity split, which is at present 50:50. Ofgem's view is that a capacity-commodity split of 90:10 would better reflect costs. Respondents' noted that this split had not been reviewed and asked for certainty on this issue, expressing concern over the stability of transportation prices given the recent history of methodology developments and rebalancing of charges. The appropriate capacity-commodity split may depend on the outcome of Ofgem's review of the interruptible regime and so it will not be possible to settle these matters until after that review.

Ofgem asked Transco to consider whether the rebalancing of charges can be phased in, given the increase in the proportion of capacity and commodity costs borne by two customer groups as noted above. Having considered Transco's response, that phasing in the rebalancing of LDZ charges would require an interim charging function that might distort price signals and cause concerns over future price stability, it has been decided not to insist on a phased rebalancing of charges.

PC71

In November 2001 Transco consulted on proposals to alter its methodology in respect of National Transmission System (NTS) charges. These changes were focussed upon Transco's asset owner (TO) functions of the NTS system, the proposals included:

- ◆ NTS capacity charges to be based on 100 per cent of the target TO revenue rather than 65 per cent of target NTS revenue;
- ◆ the NTS TO target revenue to be split 50:50 between revenue from entry capacity charges and exit capacity charges;
- ◆ in the derivation of entry and exit charges from the long-run marginal cost (LRMC) route costs that terminal specific calorific values (CVs) should be used in the calculation of LRMC per unit energy and that the entry charge at Bacton should no longer be fixed; and
- ◆ whether the basis of the LRMC calculations remained appropriate given Ofgem's TO price control proposals.

Overall, the proposals appear to contribute to improving the cost reflectivity of Transco's charges for the NTS. On the basis of the consultation and Transco's response to points raised by respondents Ofgem has decided not to veto the methodology proposals in PC71.

Yours sincerely

Andrew Walker
Director, Transportation