August 2004

TRANSCO CONSULTATION REPORT ON PC80

Introduction of Different Levels of LDZ Charges between Networks

1. Transco's Initial Proposal

In PC80 Transco proposed changing the distribution charging methodology so as to allow for different levels of LDZ charges between different networks with effect from April 2005. The proposed change is a natural consequence of the introduction of separate network price controls and allowable revenues from April 2004.

2. Summary

There were 8 responses to the consultation paper.

Shippers & Suppliers	
British Gas Trading	BGT
npower	NP
PowerGen	PG
Scottish & Southern Energy	SSE
Shell Gas Direct	SGD
Total Gas & Power	TGP
EDF ENERGY	EDF
Scottish Power	SP

One respondent (SSE) supported all aspects of the proposal. A further five respondents (NP, PG, SGD, EDF, TGP) supported the proposal to introduce differential charges, but had reservations about related issues. Two respondents (BGT, SP) opposed the proposal.

3. Detailed Responses

3.1 Necessity for differential LDZ charges

Most respondents realised that differential LDZ charges across networks were an inevitable consequence of the separation of the distribution price control. However, two respondents (BGT, SP) opposed the proposal, both being of the opinion that separate network price controls could be introduced while at the same time adjustments to charges due to under and over recoveries could be handled on a national basis through adjusting a single set of national charges. One respondent (EDF) stated that the proposed change in methodology is necessary due to the proposed DN sales. Another respondent (SP) commented that this consultation removed an existing requirement for consultation.

Transco's Response

Transco agrees with the views of the majority of respondents that it is necessary to adjust charges on a network basis to keep collected revenue in line with allowed revenue on a network basis. Special Condition 28B of Transco's GT Licence now specifies that charges must be set so as not to over-recover on a network, not a national basis. To try to comply with this condition while maintaining postalised charges could mean some networks continually under-recovering to prevent others over-recovering.

The proposed amendment to the charging methodology is due to the introduction of separate price controls and would still be necessary whether or not any DNs were sold off. Also rather than remove an existing need for consultation, PC80 replaces the need for each DN to do its own consultation to introduce differential charges with a single consultation covering all DNs.

3.2 Division of Allowed Revenues to Networks

One respondent (BGT) suggested that there needed to be a greater level of transparency in the methodology used to divide the allowed revenue between the Networks.

Transco's Response

The allocation of the allowed revenue between networks was determined by Ofgem, with the co-operation of Transco. The allocation was largely based on the share of the total distribution revenue produced in each network by the application of the current level of charges. The percentage breakdown of allowable revenues between DNs is set out in Transco's revised GT Licence, April 2004, Special Condition 28B 8 (1) (iii).

3.3 Frequency and timing of price changes

Nearly all respondents expressed concerns about the increased likelihood of changes to the charges with separate price controls and the potentially unco-ordinated timing of changes through the year by independent Distribution Network Operators (iDNs). Generally these respondents favoured some controls on the price change process and a limit on the number of changes per annum and an agreed timetable, for example, changes could only be made on 1st April and 1st October each year. Two respondents, (PG, SP) suggested changes only once per year, possibly on 1 October.

One respondent (TGP) suggested that new gas iDNs would have to go through a learning process which could result in "errors" causing unnecessary price changes. One respondent (SGD) thought it essential that DNs be allowed to smooth fluctations in revenues without being required to meet overly restrictive revenue target bands.

Transco's Response

Transco considers that the existence of iDNs should not increase the frequency of changes to the charges in any one network, but could lead to charges being changed at different times of the year in different networks. To address this a governance approach which would limit the dates on which changes could be made was suggested at the Distribution Implementation Steering Group (DISG), a working group set up by Ofgem. It is Transco's view that if there were to be restrictions on the dates when charges could be changed for the good of the industry then some of the Licence conditions, such as the 3% interest penalty on over-recovery, ought to be relaxed.

3.4 Effects on Consumers

A number of respondents (eg SGD, PG, BGT, SP) commented in varying ways about the effects on consumers. Those on pass-through contracts would face greater uncertainty about their prices and difficulties with setting budgets, and there would potentially be increased risk premiums to be built into fixed price contracts.

Transco's Response

For consumers with either type of contract located in any one network the uncertainty should be no greater than at present. However for consumers with sites in more than one network then admittedly they are likely to have to deal with different levels of charges in the different networks in due course so there will be some increase in uncertainty.

3.5 System changes and related costs

Two respondents (PG, BGT) stated that industry models are not set up to deal with differential pricing and this change would increase their costs, with one respondent (BGT) stating costs could run into tens of millions of pounds if carried out within the timescales proposed.

Transco's Response

Transco acknowledges that there will be a cost to shippers to amend their IT systems to accommodate the new regime but is unable to comment on the level of shipper/supplier costs to do this. Transco will incur costs to amend its own billing systems but estimates that the costs will be substantially below the level mentioned above.

It may be worth noting that there is already a degree of regional pricing through NTS Exit charges. Moreover, all sites above 732,000 kWh have individual LDZ and Customer prices dependent on their peak load size.

3.6 Implementation date

One respondent (BGT), whilst being opposed to the proposal, suggested that if the change went ahead then it should at least be delayed until October 2005 as the IT development costs are "exacerbated by the relatively short timescales". Another respondent (PG) had concerns about fixed price contracts running beyond the proposed implementation date, with the consequential risks faced by shipper/suppliers and consumers.

Transco's Response

Transco has some sympathy with the point about the development costs and in view of the support for a later implementation date is now willing to accept an implementation date of 1 October 2005.

With respect to fixed price contracts it is not clear why the risk associated with network charging is significantly greater than that associated with national charging, as even with national charging there was always the possibility that charges could be changed during the life of these contracts.

3.7 Transparency

There were a number of comments with respect to transparency at particular stages in the price setting process. One respondent (EDF) asked that where DNs amended prices "the process is carried out in a transparent manner". One respondent (TGP) asked for greater information disclosure, citing Mod 0698 as a way forward.

Transco's Response

The existing Licence and Network Code obligations regarding disclosure and notice periods for price changes would apply to all DNs. The proposals of Mod 0698 would mean greater information disclosure, but it is not clear how helpful this extra information would be. The final report following the consultation on Mod 0698 is currently being considered by Ofgem.

3.8 Dealing with Over-Recovery

One respondent (EDF) requested information on the procedure if a DN over-recovered in a prior year, and whether this would mean limited or no increase in charges the following year.

Transco's Response

If a DN over-recovers in one year then this over-recovery, with interest added, would be subtracted from the allowed revenue for the following year, and the DN then has the "best endeavours" obligation under the Licence to set charges for that year so as not to over-recover against the reduced allowed revenue. While what would actually happen to prices depends on the full circumstances it is probably true to say that following an over-recovery stable or reducing prices are more likely than rising prices.

3.9 Reduction in Competition

One respondent (BGT) suggested that the proposed change might result in less competition both for domestic and larger customers. They said that experience in the electricity industry had shown that there are generally only a small number of competitors in any one area, with few national players. They suggested that with the introduction of differential pricing suppliers may pick and choose which customers they wish to supply. Another respondent (SGD) suggested that different network prices would increase the complexity of non-domestic transfers.

Transco's Response

It is not clear why the introduction of differential network charges should in itself have any effect on competition. In practice any differences in network charges which do emerge are likely to be such a small proportion of the total cost of supply that they are unlikely to influence suppliers' commercial decisions. The increase in the complexity of non-domestic transfers would be limited if the structure of charges remains the same and it is only the levels which are different, which is what is proposed in this consultation.

3.10 Energy efficiency Savings

One respondent (BGT) suggested that the proposed change would result in energy efficiency savings having to be calculated and advertised on a regional basis and that this would add to customers' confusion.

Transco's Response

Provided that the energy efficiency savings are published clearly by region it is not clear why there should be any confusion. We understand that some suppliers already have regionalised prices.

3.11 Quantum meters

One respondent (BGT) suggested tentatively that there might be an issue with quantum meters and the ability of the system to charge on a regional basis.

Transco's Response

While the question is more one for metering rather than transportation our understanding is that the Quantum meter smartcards can be set for different levels of revenue recovery and therefore they should be able to cope with charging on a regional basis.

4. Meeting to Discuss PC80 – 21st June 2004

Although not a formal part of the consultation process Transco held a meeting in London on 21st June to discuss PC80 because some of the written responses suggested that some clarification of why PC80 had been raised would be helpful. The meeting allowed Transco to explain more fully the reasons behind PC80 and allowed shippers and others to share their views. Concerns were expressed not just about the different levels of charges implied by PC80 but that it would also open the way to more frequent changes in the charges and changes being made at different times of year by different networks.

A proposal that the implementation date be postponed from April 2005 to October 2005 received a significant amount of support, mainly on the basis that it would give shippers and multi-site end users more time to make the changes to their IS systems which would be necessary to accommodate the new charging regime.

Transco's Response

Transco explained that a governance approach which would aim to limit both the frequency of price changes and the dates on which prices could be changed had been suggested. With respect to the proposed delay in the implementation date, Transco considers there are good reasons for keeping the implementation date as April 2005. The main reason would be to allow Transco and any independent DN operators that there might be at that time to be in a position to comply with Special Condition 28B 6 (1) which puts a "best endeavours" obligation on the Licensee to set charges so as not to over-recover on a network basis.

It has been Transco's opinion that in order to comply with this obligation the proposed change in the charging methodology should be implemented from 1 April 2005. However given the support that there is for an October 2005 implementation date Transco is willing to accept this later implementation date.

However shippers and others should be aware that if differential price changes become necessary for the formula year 2005/06 then because the changes cannot be made until October may mean that the percentage changes need to be higher than they would have been had they been implemented in April.

5. Transco's Final Proposal

Transco welcomes the comments received in response to the proposals made in PC80. A majority of the written responses were in favour of the introduction of differential charging, but particularly at the meeting on 21st June there was support for an implementation date of October 2005 rather than April 2005. Having given due consideration to all the views expressed Transco is willing to accept the later implementation date and therefore makes the following final proposal:

That the distribution charging methodology be amended so as to permit differential network charging with effect from 1 October 2005.