



Gas Transporters, shippers and interested parties

*Promoting choice and value for all customers*

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Dear Colleague,

## **Modification of Standard Special Condition D11 of the GT licence**

### **Introduction**

1. Against a background of significant variability in the level of gas distribution charges since the introduction of individual Gas Distribution Network (GDN) charging regimes following DN sales, Ofgem is proposing to modify Standard Special Condition (SSC) D11<sup>1</sup> of the Gas Transporter (GT) licence in a manner that will increase stability in the level of charges. The proposed licence modification will:
  - change the date on which a GDN can amend distribution charges from 1 October to 1 April each year, retaining the requirement to amend charges only once a year unless otherwise directed by the Authority by notice in writing.
2. This letter sets out the rationale behind the proposed licence modification and invites relevant licensees to indicate whether they are minded to accept or reject the modification. A draft of the amended SSC D11 is set out in the Appendix, which is attached to this letter. Responses should be sent to [indra.thillainathan@ofgem.gov.uk](mailto:indra.thillainathan@ofgem.gov.uk), to be received no later than 5.00pm on 16 January 2008.

### **Background**

3. Under SSC D11 of the GT licence that governs charging, the GDNs have a reasonable endeavours obligation to only amend distribution charges once a year on 1 October, or at any other time as directed by the Authority.
4. Ofgem has been reviewing this obligation against a background of significant variability in gas distribution charges since DN sales in 2005, and a number of other subsequent developments. These include, the removal of any volume related revenue driver from the 2007-08 and 2008-13 price controls, extension of a capacity based customer charging function to domestic supply points, the proposal to increase the capacity element of Use of System charges to 95% of collected revenue from 1 October 2008 and the raising of UNC Modification proposals 160 and 162, to enable shippers better forecast future movements in transportation charges.

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<sup>1</sup> *SSCD11: Charging obligations*

5. In October 2006 Ofgem consulted<sup>2</sup> on aligning the charging and formula years, by changing the date on which GDNs are allowed to amend distribution charges from 1 October to 1 April. It was considered that removing the mis-match between charging and formula years would reduce variability in the level of charges. Of the eight responses to this consultation the majority supported the proposal. The two in opposition considered that retaining the ability to amend charges on 1 October was imperative as it allowed GDNs to take into account the effect on allowed and collected revenues of variations in system throughput during the first half of the formula year.
6. Subsequently, in July 2007 we published an open letter<sup>3</sup> inviting comments on a proposal to permit GDNs to amend distribution charges twice a year on both 1 October and 1 April. Thirteen responses were received, six from gas transporters and seven from shippers. Six supported the proposal on the basis that it would reduce variability in the level of charges. The other seven opposed it not because they wished to see variability continue, but because they believed it to be unnecessary given a number of other measures under consideration, which if implemented would achieve the same objective. These measures included the GDPCR proposal to remove the volume related revenue driver and the GDNs' proposal to increase the capacity element of Use of System charges.
7. Shippers also expressed the view that predictable and transparent charges were as valued as stable charges and that UNC Mod 160 if implemented could give shippers better information to predict the direction and magnitude of future movements in the level of distribution charges. A number of those opposed to the change continued to support the move to an April charging year on which we first consulted.
8. In our draft Impact Assessment on DNPC03<sup>4</sup> we stated that we would defer any decision on modification of the licence obligation until after a determination had been made on DNPC03. This prompted three respondents to submit comments, all of whom were opposed to biannual amendments to charges. They considered the proposal to be unnecessary and detrimental to competition and therefore to customers.

## Analysis

9. The requirement that distribution charges can only be amended on 1 October, mid way through the formula year, magnifies the variation in distribution charges necessary to achieve a given variation in annual collected revenue. In addition, distribution charges for the first six months of the preceding formula year will be at a level that does not reflect allowed revenue in that year. This increases the divergence between allowed and collected revenue and the variation in distribution charges required the following October. Variability will therefore tend to be reinforced over time. As the proportion of revenue recovered by capacity charges has increased so both these effects have been magnified as Table 1 below illustrates.
10. For example, under the pre 1 April 2007 charging structure to raise an additional one percent in collected revenue over the formula year, a GDN had to raise charges by 1.6% in October. However, moving to the revised charging structure to be implemented from 1 October 2008, the equivalent figure would increase to 1.97%. This is because under the new charging structure less revenue will be collected in the second half of the year than was previously the case.

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<sup>2</sup> Reform of interruption arrangements on gas distribution networks – An update, October 2006

<sup>3</sup> Proposal to modify Standard Special licence conditions A4, A5 and D11 of the Gas Transporter licence, 20 July 2007

<sup>4</sup> DNPC03 - LDZ System Charges Capacity Commodity Split and Interruptible Discounts, Draft Impact Assessment, 30 October 2007

**Table 1: Magnification of distribution charge variability due to 1 October change date**

Structure of Distribution charges	Revenue Collected		1 October magnification
	April – Sept	Oct – March	
Pre 1 April 07	38%	62%	1.60
1 April 07 – 30 Sept 08	43%	57%	1.75
Post 1 Oct 08	49%	51%	1.97

11. Even with system throughput removed as a significant source of variability, year on year variability may continue to be experienced during the 2008-13 price control period. This is because a number of incentives and adjustments, as shown in Table 2, have been included within the control that will cause year on year variations in a GDN's allowed revenue.

**Table 2: Elements contributing to allowed revenue**

Core allowed revenue	GDPCR year on year allowance Inflation
Uncontrollable Costs	Formula Rates PGT licence fees Pensions deficit charge Shrinkage
Incentives	Meter work Revenue Driver Mains & Service Replacement Capacity Outputs Emissions IFI
Previous under / over recovery	K

12. In any event, the majority of these elements (in value terms) will be known at the start of each year or at the start of the price control period. GDNs will therefore be able to set charges at the beginning of the year which will enable them to collect their allowed revenue, and in future years we would expect the K adjustment to be smaller. This means that charges for future years will be more predictable, which we know shippers consider to be important.

### Final proposal

13. Based on responses to previous consultations and analysis undertaken by us we recommend retaining the GDNs' reasonable endeavours obligation to amend distribution charges once a year unless otherwise directed by the Authority by notice in writing, but that the timing of the change should be moved from 1 October to 1 April each year.

14. We recommend that this proposal should become effective on and from 1 April 2009. For the avoidance of doubt, charges can change on 1 October 2008, then on 1 April 2009, and thereafter only on 1 April or at such other time as directed by the Authority.

### Next steps

15. GDNs are asked to indicate by 16 January 2008 whether they are minded to accept or reject the proposed licence amendment. A draft of the modified licence condition is set out in the attached appendix. Pending licensees' responses, we propose including the

modification of SSC D11 in the notices of proposed licence modifications scheduled for mid February 2008 in support of GDPCR.

16. Please contact me on 020 7901 7294 if you would like to discuss this letter.

Yours sincerely,

Indra Thillainathan  
Senior Analyst  
Gas Distribution Policy

## Appendix – Draft licence condition

This appendix includes a draft of the proposed amendment to Standard Special Condition D11.

### Standard Special Condition D11. Charging obligations

#### 1. Amendments to Standard Special Condition A4 (Charging - General)

Standard Special Condition A4 (Charging – General) shall be amended by:-

- (a) in paragraph 1, the insertion of “, for each Distribution Network (as defined in Special Condition E2A (Revenue Restriction Definitions in respect of the Distribution Network)), where applicable,” after the words “the licensee shall”;
- (b) in paragraph 2, the insertion of the following in sub-paragraphs (a) and (b) in substitution for the words “NOT USED”:
  - “(a) use its reasonable endeavours not to make any changes to the charges or reserve prices mentioned in paragraph 1 more frequently than once in each formula year ~~and for~~ such that before 31 March 2009 any changes ~~to shall~~ take place on 1 October in each formula year and after 31 March 2009 any such change shall take place on 1 April in each formula year or in either case, at such other time as the Authority ~~may~~ by notice in writing direct;
  - (b) subject to sub-paragraph (a) above, if the licensee makes changes to the charges or reserve prices mentioned in paragraph 1 on a date other than that specified in sub-paragraph (a), inform the Authority in writing as soon as is reasonably practicable after the decision is made to make such a change to charges, and, in any event, not later than three months after the charge change has been implemented:
    - (i) stating the reasons for this change; and
    - (ii) clearly identifying whether any of the information is of a confidential nature.”