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Modification proposal:	**Uniform Network Code (UNC) 418/418A: Review of Local Distribution Zone (LDZ) Customer Charges**		
Decision:	The Authority[1] has decided to reject this proposal[2]		
Target audience:	The Joint Office, Parties to the UNC and other interested parties		
Date of publication:	5 February 2014	Implementation Date:	N/A

Background to the modification proposal

The charge a customer must pay for use of the Gas Distribution Network (GDN) includes a system charge to recover the cost of 'upstream' network activities, and a customer charge to recover the cost of 'downstream' network activities.

The following costs are included in the customer charge -

- *Supply point emergency service costs*: the cost of emergency teams called out when a leak is reported downstream of the main. This includes an allocation of overheads and call centre costs.
- *Services replacement costs (repex)*: the cost of replacement services funded by the transporter or adopted by them. This includes leakage which represents a small element of costs associated with services.
- *Asset related costs:* the depreciation of the capital costs of services funded by the transporter. The majority is the cost of the Domestic Load Connection Allowance (DLCA), which socialises the cost of the first 10 metres of service laid in public property to domestic properties situated within 23 metres of an existing main. It also includes network rates based on the capital cost of services funded by the transporter, which represents a small element of asset related costs.

The structure of the customer charge is different across the three charging bands, designated according to customer's Annual Quantity (AQ) of gas used -

- 0-73.2MWh: unit rate supply point capacity (SOQ) based charge.
- 73.2-732MWh: unit rate SOQ based charge plus a fixed charge depending on frequency of meter reads.
- >732MWh: unit rate charge based on a power of the customer's SOQ.

The modification proposal

UNC modification proposal 418/418A reviews the structure of customer charges. Two alternate proposals have been put forward to change the structure of the charge. Both propose the same treatment of non-asset related costs.

Supply point emergency service costs

The GDNs have no evidence that these costs vary with supply point size. Therefore under both proposals they would be recovered by a single 'pence per supply point per day' flat rate charge which would apply to all supply points.

[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] This document is notice of the reasons for this decision as required by section 38A of the Gas Act 1986.

Services replacement costs (repex), including leakage

For most GDNs, there is evidence that these costs are higher for non-domestic supply points than for domestic supply points as non-domestic supply points will on average have larger services. However, there is no evidence that costs vary by supply point capacity within domestic or non-domestic categories. There would therefore be a 'pence per supply point per day' flat rate for the 0-73.2MWh charging band which consists mainly of domestic supply points, and a slightly higher flat rate for the other bands.

The proposed approach to the structure of charges to recover asset related costs, which includes both services depreciation and network rates, is different in each modification proposal. UNC418 proposes that asset related costs be recovered by a flat rate charge applied to all supply points irrespective of size. The proposer considers that as the majority of these costs relate to the DLCA, cost recovery was never intended to be cost reflective and should be spread evenly across all customers. UNC418A proposes that asset related costs be recovered by a 'pence per kWh' flat unit rate charge applied to all Supply Points irrespective of size. This is to insulate domestic customers who benefitted from the DLCA from these costs. The proposer considers that this was the intent of the Gas Act (1985).

The proposers of UNC418 and 418A believe these proposals support Relevant Charging Methodology Objectives[3] (the "Relevant Objectives") (a) and (b). The proposers consider that the modifications would further Relevant Objective (a)[4], as the customer charge would reflect more accurately the costs incurred by each GDN. The proposers consider that the modifications would support Objective (b)[5] as each would make the structure of the customer charge correspond to the existing structure of the distribution networks.

UNC Panel[6] recommendation

Members of the UNC Panel voted on the proposals on 19 December 2013. Following the vote, the Panel recommended that:

- proposed Modification 418 better facilitates the Relevant Objectives than proposed Modification 418A;
- proposed Modification 418 should be made; and
- proposed Modification 418A should not be made.

Our decision

We have considered the issues raised by the modification proposal and the Final Modification Report (FMR) dated 20 December 2014. We have considered and taken into account the responses to the Joint Office's consultation on the modification proposal which are attached to the FMR[7].

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[3] As set out in Standard Special Condition A5(5) of the Gas Transporters Licence, see: https://epr.ofgem.gov.uk//Content/Documents/Standard%20Special%20Condition%20-%20PART%20A%20Consolidated%20-%20Current%20Version.pdf

[4] As set out in Standard Special Condition A5(5) (a) of the Gas Transporters Licence, see footnote 3.

[5] As set out in Standard Special Condition A5(5) (b) of the Gas Transporters Licence, see footnote 3.

[6] The UNC Panel is established and constituted from time to time pursuant to and in accordance with the UNC Modification Rules.

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

We have concluded that implementation of the modification proposal will not better facilitate the achievement of the relevant objectives of the UNC[8].

Reasons for our decision

In reaching our decision we have assessed the modification proposal against the Relevant Objectives. The reasons for our decision are set out below.

Relevant Objective (a): save in so far as paragraphs (aa) and (d) apply, that compliance with the charging methodology results in charges which reflect the costs incurred by the licensee in its transportation business.

We note that the introduction of the SOQ based charge was intended to increase cost reflectivity as SOQ is a key driver of GDN costs. Approximately 70% of GDNs' allowed revenues are recovered through system charges, of which 95% are based on SOQ. We believe that, in the absence of evidence to the contrary, basing charges with unidentified cost drivers on SOQ would most accurately preserve the GDN charging differentials determined by system charges and would be more cost reflective than other approaches.

We have not seen any evidence that identifies the drivers for supply point emergency service costs. It is not clear what structure of charges most accurately reflects the cost drivers. The GDNs have provided evidence which demonstrates that services replacement costs across the majority of the networks are higher for non-domestic than domestic supply points. We accept the argument that domestic customers usually fall into the lowest charging band based on AQ, and that non-domestic customers usually fall into the higher bands. We have not seen any evidence that supply point capacity is a cost driver within these customer classes. We agree with a number of respondents to the consultations that there is no clear driver for the structure of charges for DLCA costs as condition 4B of the Gas Transporters Licence[9] requires that these are socialised across all customers. Therefore, the different approaches proposed in UNC418 and UNC418A for these costs do not further this Relevant Objective. The wider implications of the two structures of charges for these costs are considered in more detail below. We consider, therefore, that due to the treatment of services replacement costs only, both proposals marginally better facilitates this Relevant Objective.

Relevant Objective (b): that, so far as is consistent with sub-paragraph (a), the charging methodology properly takes account of developments in the transportation business.

We note that the UNC Workgroup and the UNC Panel considered that UNC418 and 418A would better facilitate the achievement of Objective b) because it would make the structure of LDZ customer charges reflect the structure of the distribution networks, and so reflect network sales.

We have not seen a robust explanation of why this modification directly reflects changes in ownership of transportation businesses as a consequence of network sales. We have

[8] As set out in Standard Special Condition A5(5) of the Gas Transporters Licence, see: http://epr.ofgem.gov.uk/Pages/EPRInformation.aspx?doc=http%3a%2f%2fepr.ofgem.gov.uk%2fEPRFiles%2fStandard+Special+Condition+PART_A_-_Consolidated_-_Current+Version.pdf

[9] For condition 4B of the Gas Transporters Licence, see https://epr.ofgem.gov.uk//Content/Documents/Gas_transporter_SLCs_consolidated%20-%20Current%20Version.pdf

also not seen a robust explanation or sufficient evidence of why taking account of an industry change in 2005 constitutes facilitation of this Relevant Objective in 2014 as this is not a recent development in the transportation business.

Relevant Objective (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.

We note that some members of the UNC Panel considered that UNC418A better facilitates this Relevant Objective by preserving the intent of the DLCA and therefore avoiding distorting the market, aiding effective competition between shippers. However, we note that in April 2007 the GDNs implemented a change to the methodology which, for the 0-73.2MWh charging band, changed the customer charge from a 'pence per kWh' charge to the current SOQ based charge. This was considered appropriate on the grounds that it would lead to more stable charges which would benefit shippers. UNC418A would reverse this change. Furthermore, the available evidence shows that UNC418A would have a high impact on the charges faced by some groups of customers, changing the GDN charging differentials determined by system charges. We therefore do not support the view that UNC418A better facilitates this Relevant Objective.

We note that some members of the Panel considered that UNC418 would better facilitate this Relevant Objective as the cost structure for asset related costs would be non-discriminatory and consistent with maintaining stable and predictable transportation charges, enabling effective competition. However, the current SOQ and capacity charges are already fixed within year and relatively stable between years. As noted, the purpose of introducing charges based on SOQ was to increase stability. We have not seen evidence to show that UNC418 would lead to materially lower volatility in charges. Therefore we are not convinced that the proposal better facilitates this Relevant Objective.

We note that Xoserve is forecasting up to £1m in implementation costs. Furthermore, a number of suppliers have indicated they would have to review customer tariffs and potentially incur costs. We do not consider that this level of costs would be reasonable given the lack of clear benefit to customers.

Furthermore, we are concerned that as average domestic charges are lower than non-domestic charges, a flat rate 'pence per supply point per day' charge proposed by UNC418 for asset related costs and supply point emergency service costs would place a proportionately larger charging burden on domestic customers. Domestic customers would see an increase in total charges of between 1-1.9 per cent while the largest users would see decreases of between 5.7-9 per cent. We consider this to be disproportionate given the lack of well evidenced justification provided that this proposal facilitates the identified Relevant Objectives and given the forecast implementation cost. In exercising our function of approving modification proposals, we do not consider that approving UNC418 would be in the interests of existing and future consumers.

The impact of UNC418A on a number of market segments is high. Domestic customers are likely to see reductions in charges of between 3.1-6.7 per cent while the largest customers would see increases of between 97-150 per cent. We do not consider that this will produce a more reasonable distribution of costs and there is inadequate justification for this approach. We therefore consider that UNC418A is not in the interest of existing and future consumers.

This letter constitutes notice pursuant to section 38A of the Gas Act 1986 of the reasons for our decision.

Andy Burgess
Associate Partner, Transmission and Distribution Policy

Signed on behalf of the Authority and authorised for that purpose.