

Modification proposal:	Modification Proposals to the Gas Transmission Transportation Charging Methodology NTS GCM06 'Further Revision to Obligated NTS Entry Capacity Reserve Price Determination'		
Decision:	The Authority¹ has decided to veto this proposal²		
Target audience:	NGG and other interested parties		
Date of publication:	11 July 2007	Implementation Date:	N/A

Background to the modification proposal

On 24 April 2007 the Authority approved GCM01: Alternative Methodologies for Determination of NTS Entry and Exit Capacity Prices³. This modified the gas transmission transportation charging methodology (the "Methodology") under Standard Special Condition (SSC) A5 (Obligations as Regard Charging Methodology) (the "Condition") by replacing the Transcost model with a transportation model.

During its consultation on GCM01, NGG had consulted on two specific options regarding the transportation model. The first of these, designated "option 2a", proposed using forecast flows as the basis for setting entry capacity charges. The option that was eventually incorporated in the charging modification proposal was the use of the obligated baseline entry capacity level ("option 2b") in the entry charge calculation.

The importance of appropriate locational signals reflecting spare capacity

Although Ofgem approved the model with option 2b, the decision letter on GCM01 asked NGG to re-consult on the use of forecast flows (as a proxy for spare capacity) in the transportation model. In the decision letter we reconfirmed our long held view that it is important that the charging methodology provides appropriate locational price signals to users by reflecting the costs of providing network capacity at different points on the network. But we said that it was important to consider how the charging methodology took account of "spare capacity" on the network and encouraged shippers to use spare capacity where possible when considering where to connect new sources of supply. This may be a feature at certain network locations given long network asset lives and the continuing decline in production from offshore gas fields. As the network assets at these locations will already have been included in NGG's Regulatory Asset Value (RAV) (assuming that they were deemed efficient by us as part of the capex review at the time of the relevant price control), consumers would ultimately pay for these assets whether they are used or not. Where spare capacity exists the charging methodology should provide appropriate signals to users to use this spare capacity if it would be cheaper than bringing gas on at other points of the network where investment would be required to provide additional capacity.

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.

²This document also constitutes notice of the reasons for this decision as required by section 38A of the Gas Act 1986.

³ http://www.nationalgrid.com/NR/ronlyres/4B3C0111-9F1B-4834-9897-8465CB0559BA/17737/NTSGCM06ConclusionsReportEntryCapReservePricesV1_2.pdf

The charging modification proposal (“the Proposal”)

NGG is proposing to amend the Methodology by using the maximum forecast base case supply level for setting entry prices, rather than the obligated entry capacity level. This means that at aggregate system entry points (ASEPs) where the forecast flows are below the obligated entry capacity level, prices would be lower compared with those proposed under NTS GCM01. This approach will therefore result in lower prices at terminals where there is spare capacity available.

Justification of the Proposal

NGG considers that the Proposal promotes the economic and efficient use of network assets by incentivising the use of underutilised assets. It further considers that since it will have an obligation to use reasonable endeavours to undertake capacity substitution, basing prices on forecast flows rather than obligated baseline levels could be more cost reflective. Additionally, it notes that the Proposal continues to avoid undue preference in pricing and promotes competition through allowing interested parties to replicate and forecast prices, in line with the current approved Methodology.

Responses to GCM06

NGG received nine responses to the GCM06 consultation, seven of which opposed its implementation with the remaining two supporting the Proposal. Common reasons for opposing the Proposal were that:

- it would increase the risk of revenue under recovery from entry capacity charges relative to price control allowed revenues, leading to higher commodity charges and charging volatility
- discounting the entry capacity price is not likely to drive the particular choice of ASEP
- the use of obligated baselines is more cost reflective and avoids cross-subsidy
- it introduces subjectivity through the use of forecast data, which is also subject to manipulation
- it runs contrary to the simplicity and transparency objectives when replacing Transcost

The reasons for supporting the Proposal were:

- it should lead to a more efficient use of the transmission system and avoid unnecessary investment
- it facilitates the development of marginal fields and import projects
- it is more cost reflective and stable when substitution is implemented

The Authority’s decision

The Authority has considered the issues raised by the modification proposal and the Final Modification Report (FMR) dated 13 June 2007. The Authority has considered and taken into account the responses⁴ to NGG’s consultation and responses to the impact assessment carried out by Ofgem. The Authority has concluded that:

- 1. implementation of the modification proposal will not better facilitate the achievement of the relevant objectives of the Methodology⁵; and**

⁴ NGG modification proposals, modification reports and representations can be viewed on the NGG website at www.nationalgrid.com

⁵ As set out in Standard Special Condition A5(5) of NGG’s Gas Transportation Licence, see: http://epr.ofgem.gov.uk/document_fetch.php?documentid=8783

2. deciding to veto the proposal is consistent with the Authority's principal objective and statutory duties⁶.

Reasons for the Authority's decision

Concerns about the clarity of the proposal and the consultation process followed by NGG

Ofgem is concerned that the proposal consulted upon by NGG is not sufficiently well explained for respondents to be able to understand and comment on it. This issue was also raised in the responses. NGG's explanation of the proposed methodology is difficult to follow and understand and would have benefited from greater clarity and the use of numerical, worked examples (or accompanying spreadsheet models) to allow shippers to understand all the inputs, assumptions and calculations that are made at each stage of the methodology.

Furthermore, whilst assessing NTS GCM06 and comparing prices with NTS GCM01 Ofgem noted a number of apparent data discrepancies. This resulted in NGG submitting new sets of prices both reflecting the inclusion of spare capacity (as under NTS GCM06) and the exclusion of spare capacity (as under the existing methodology NTS GCM01). This is a significant cause of concern even though NGG indicated that prices in the consultations were indicative. It seems that some errors had been made whilst calculating these prices. Some errors involved the definitions which were used to determine the level of obligated entry capacity. At certain entry points this resulted in material changes to prices.

The consultation relates to the methodology and not the prices themselves. But the methodology is based on a range of complex calculations and assumptions. A useful way to assess such whether such a complex model is producing output prices that are reasonably cost reflective is to see whether the resulting prices make intuitive sense. We therefore think it is reasonable, in assessing the methodology, for shippers to be able to assess the robustness of the model and whether it is meeting the objectives by considering the outputs. NGG's failure to provide robust information on indicative prices has prevented shippers from being able to apply this scrutiny.

The concerns expressed above underpin our decision to veto.

Compliance with the charging methodology results in charges which reflect the costs incurred by the licensee in its transportation business – SSC A5(5)(a)

We still think, for the reasons set out in our decision letter on NTS GCM01, that it would be in customers' interests to include spare capacity in the model. We also recognised that in the short-term it might be appropriate to do so through adopting option 2a of NGG's November 2006 consultation document⁷, whilst exploring whether there are better ways of incorporating spare capacity in the longer term.

Incorporating spare capacity should reduce the risk of inefficient decisions on where to land gas and of customers having to pay for underutilised assets on the network as a result.

⁶The Authority's statutory duties are wider than matters which the Panel must take into consideration and are detailed mainly in the Gas Act 1986.

⁷ NTS GCM01: Alternative Methodologies for Determination of NTS Entry and Exit Capacity Prices, National Grid, 2 November 2006

We do not agree with the view expressed by many respondents that price does not play a role in deciding where to locate a new entry terminal or expand an existing terminal. There is evidence that this is not the case. The decision to locate the Langeled pipeline at Easington appears, at least in part, to have been driven by the relative prices of entry at different locations on NGG's network. The location of other new import infrastructure – including the BBL pipeline and the Isle of Grain LNG terminal may also have been influenced by relative entry prices. Looking forward – decisions on where to land gas from the Troll field, from gas reserves West of the Shetland Isles and from new LNG terminals could also be influenced by relative entry prices.

We also do not agree that incorporating spare capacity would lead to revenue under-recovery from entry charges and higher commodity charges. In setting entry charges to provide appropriate locational signals (including signalling spare capacity) what is important is the relative charges between different entry points not the absolute level of charges. It is therefore possible as part of the methodology to uplift all entry charges to recover the required level of allowed revenue whilst maintaining the locational signals.

We accept that the incorporation of spare capacity might lead to greater charging volatility. But shippers can protect themselves from this volatility by fixing their prices through the long term auctions. Volatility is not a concern if it genuinely reflects changes in the relative costs of providing capacity at different points on the network. This could occur for example, if there is large new source of supply that has a significant impact on patterns of flows across the network. As long as the methodology is clear and transparent and NGG publishes clear information on the likely evolution of charges under the methodology for a range of supply and demand scenarios shippers should be able take their own view and manage their exposure to any changes in entry charges.

Some respondents expressed concerns that the use of forecast entry capacity flows as a proxy for the inclusion of spare capacity introduces subjectivity and is open to data manipulation. We think these concerns are reasonable but could be addressed by ensuring sufficient transparency and consultation on all of the assumptions and input data to the model. NGG has a range of licence obligations that Ofgem polices. These should also reassure shippers that NGG would face tough penalties if it was found to have manipulated data.

We also note that when asked, NGG was not able to provide us with firm prices for the forthcoming RMSEC and AMSEC auctions based on the proposed methodology. This was due to some further data quality issues. Suffice to say, that they have been brought to our attention at this stage in the process is a matter of great concern to us. We therefore share the concerns of some respondents with respect to data quality.

Given the lack of clarity in NGG's explanation of the proposals and the errors in the indicative charges, we have not been able to determine whether NTS GCM06 would result in more cost reflective charges compared with NTS GCM01. Consequently, the proposed model cannot be assured of better facilitating the relevant objective.

The reserve price is set at a level best calculated to promote efficiency and avoid undue preference in the supply of transportation services – SSC A5(5)(aa)(ii)(I)

Those opposed to the implementation of the Proposal have claimed that since offshore fields can only use the local infrastructure and cannot relocate, shippers will not be able to respond to the locational price signals at declining terminals. However, supporters of

the Proposal claim that the locational signals facilitate the development of marginal fields and potential import projects. Ofgem believes that with the appropriate locational signals in place, there will be opportunities for shippers to respond to the availability of spare capacity and thus maximise the use of existing network infrastructure. New import facilities (both pipeline and LNG) will have some flexibility over where they locate – the Norwegian producers have already indicated this and there are a range of proposed LNG terminals at different locations.

However, due to the data quality issues which have arisen whilst Ofgem has been assessing the proposal, Ofgem is unable to determine whether this proposal would currently promote efficiency and avoid undue preference. We are also concerned that given that some of the figures in the final modification report may have been calculated on an incorrect basis, shippers would potentially have based their views on incorrect information. This clearly applies to both NTS GCM01 and NTS GCM06.

We also note that the way in which the charging methodology has been presented to stakeholders might have been less than clear. We believe it is essential that users have a good understanding of the charging methodology and we also expect there to be a high degree of transparency in relation to inputs and outputs.

Consequently, the proposed model cannot be assured of better facilitating the relevant objective.

The charging methodology properly takes account of developments in the transportation business - SSC A5(5)(b)

Some respondents have raised concerns that the inclusion of spare capacity could result in more volatile charges. We accept that charging stability is an important criterion when assessing any charging model. We believe that it is important that a charging model is subject to sensitivity testing to make sure that very small changes in the assumed patterns on flows would not result in large changes to charges. However, we also believe that it would be wrong to artificially suppress changes in transportation charges from year to year where there are sound reasons for such changes (for example, if there are significant changes to patterns of gas flows on the network). Ultimately, when faced with a trade off between charging stability and cost reflectivity, the cost reflectivity criterion should prevail in our view. We would also like to note that the current arrangements enable users to protect themselves from charging volatility through buying capacity at a fixed price for a large number of years.

As previously stated, it is very important that the charging methodology provide appropriate locational signals, both in relation to spare capacity and changing sources of supply from year to year. Especially considering that we might see very different patterns of supply and demand year by year due to the fact that supply capacity exceeds demand, the increased ability to export and import and the increase in LNG.

NGG noted that in view of the proposed new obligation with regard to capacity substitution, the use of forecast flow capacity when setting entry prices should align more closely with changes in actual flows on the system, thereby taking account of developments in the transportation business. However, it is unclear to us how the proposal would take account of requested trades or transfers of capacity given its reliance on forecast flows. Since these mechanisms could have a significant impact on flows in some parts of the network, we cannot state that GCM06 properly takes account of developments in the transportation business.

In summary, Ofgem remains firmly of the view that the charging methodology would be better facilitated by the inclusion of spare capacity, such that system asset usage is maximised and unnecessary investment is avoided.

However, on the basis of the analysis presented by NGG, we cannot be confident that the proposal GCM06 is any more cost reflective than the current methodology.

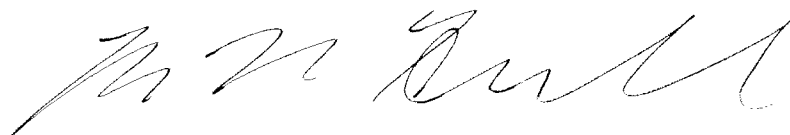
These issues remain very important given the number of new LNG, storage and import projects that are still being considered. We therefore expect NGG to carry out further development and consultation on this issue and to address the concerns we have highlighted about the process followed to date.

We therefore would expect from NGG:

- to carry out a study to assess how significant the issue of spare capacity is on the network and look at the potential cost savings (in terms of avoided investment) if some of the planned new import facilities choose to locate at locations where there is spare capacity;
- to carry out further development work on its charging methodology. Before bringing forward further proposals for consultation with stakeholders we think NGG should consider seeking independent academic advice – from an acknowledged expert in charging design – to identify the possible options for developing the charging methodology to provide appropriate locational signals where there is spare capacity and where the sources of supply could vary from year to year;
- to re-consult with stakeholders on different options for inclusion of spare capacity – and provide a much clearer explanation of each option and the current methodology including spreadsheets, worked numerical examples and the entry prices under each option to allow shippers to provide informed comments;
- to address data quality and associated transparency issues as a matter of urgency; and
- to resubmit a charging methodology proposal which incorporates the outputs of the above actions by 1 April 2008.

Decision notice

In accordance with Standard Special Condition A5 of NGG's Gas Transportation Licence, the Authority has decided to veto modification proposal GCM06: Further Revision to Obligated NTS Entry Capacity Reserve Price Determination.



Robert Hull
Director of Transmission

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