nationalgrid

CONCLUSIONS REPORT TO THE AUTHORITY

Modification Proposals to the Gas Transmission Transportation Charging Methodology

NTS GCM 09:

TO Over Recovery Mechanism

1st October 2007

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1 Executive Summary

This document sets out National Grid NTS's final proposals for amending the Gas Transmission Transportation Charging Methodology (the "Charging Methodology") in respect of the prevailing TO Over Recovery Mechanism. In the event of TO over recovery, the mechanism leads to a credit being paid to all Users based on their Monthly System Entry Capacity (MSEC) holdings and NTS Entry Capacity buy-back costs. NTS Entry Capacity buy-back costs represent a cost to Users via the Entry Capacity Neutrality charge. This report follows the completion of a 31 day consultation on Consultation Paper NTS GCM 09.

From 1st October 2007 the TO Entry Commodity charge rate will be set at or close to zero as a result of the revenue implied by the 2007 AMSEC auction and forecast revenue for the remaining rolling monthly NTS Entry Capacity (RMSEC) auctions. Actual revenue resulting from the remaining RMSEC auctions and TO revenue resulting from the TTSEC processes introduced through UNC Modification Proposal 0169 may result in TO Entry over recovery.

The prevailing TO over recovery mechanism may result in credits being less than both the buy-back costs and the revenue over recovery in the formula year hence the process may be inefficient in redistributing excess revenue. This is largely due to the over recovery amount being divided by the remaining months within the formula period and the fact that credits are only paid against buy-back costs that occur during or after the month in which over recovery has been identified. Buy-back costs from earlier in the formula year but prior to over-recovery being identified might not be included; for example auction revenue might not imply over recovery until February but buy-back costs might have been incurred in the months up to January.

National Grid NTS proposes through this GCM09 consultation report that:

Trigger

- The TO over-recovery mechanism would be triggered if the revenue implied by NTS Entry Capacity auctions breached either the Licence obligation not to exceed the maximum NTS transportation owner revenue ($TOMR_t$) by more than 4% in any formula year or not to exceed the maximum NTS transportation owner revenue by more than 6% over any two consecutive formula years
- The process would be triggered at any point during the formula year based on the outcome of any NTS Entry Capacity auction that represented a TO revenue stream

Mechanism

- The over recovery amount will be calculated as the difference between TO Entry Revenue and TO Entry Target Revenue.
- The full over recovery amount would be available in relation to the first month for which the mechanism was triggered
- The credit would offset buy-back costs and hence daily capacity & over-run revenue could represent an additional credit
- Any residual over recovery at the end of a month would be rolled forward to the next month
- Any residual over recovery at the end of the formula year would be used to offset buy-back costs in those months within the formula period when buy-back costs had occurred and no credit had been paid or where the credit was less than the buy-back cost

Implementation

It is proposed that these arrangements are implemented to define the TO Over Recovery Mechanism from 1st November 2007. National Grid NTS recognises that this is not consistent with its reasonable endeavours obligation to change the charging methodology only on 1st October or 1st April in a formula year, however, proposed implementation is largely in response to the introduction of the TTSEC process, which was designed to auction capacity from 1st November.

Future Proposals

This proposal represents an incremental change to the prevailing over-recovery methodology. The proposal may not, in practice, redistribute the full over recovery amount as buy-back costs may be less than the over recovery amount. National Grid NTS has, with the Gas Transmission Charging Methodology Forum (TCMF), further investigated other options including the potential to introduce a TO Entry Commodity Charge rebate and a retrospective negative TO Entry Commodity charge in order to further reduce the risk of over recovery and will bring forward separate proposals as required.

2 Introduction

2.1 The TO Entry Commodity charge rate will be set at or close to zero as a result of the revenue implied by the 2007 AMSEC auction.

2.2 Revenue resulting from the RMSEC auctions and TO revenue resulting from the TTSEC processes introduced through UNC Modification Proposal 0169 may result in TO revenue over recovery.

2.3 Entry and Exit TO revenue are managed separately and TO charges are set such that 50% of TO allowed revenue, other than that revenue collected through the DN Pensions charge, is collected 50% from Entry and 50% from Exit.

2.4 TO Exit Capacity charges are based on administered prices which are designed to collect all TO Exit allowed revenue. TO Entry Capacity charges are based on pay-as-bid auctions and any under recovery is managed by setting the TO Entry commodity charge.

2.5 The TO Entry Commodity charge cannot currently be used as an over recovery mechanism for Entry over-recovery and hence the TO Entry Commodity price cannot be set to have a negative value. The TO Entry over recovery mechanism is based on paying credits which offset entry capacity buy-back costs, as explained in section 3.

2.6 The following table outlines the history of the development of the TO over and under recovery mechanisms. The table gives the relevant Pricing Consultation paper number and title along with a brief summary of the proposal and the Authority decision.

Number	**Title**	**Proposal**	**Decision**
PC65	Alternative Methods of Funding Entry Capacity Constraint Management	If auction implied revenue is more than 10% above the target TO allowable revenue, this excess is divided into monthly amounts and is used to pay a credit which offsets the capacity neutrality entry capacity buy-back costs	**Not vetoed**
PC66	Transportation Charge adjustment following Entry Capacity Auctions	Any under recovery would be accounted for through the generality of transportation charges rather than just the NTS Commodity charge	**Not vetoed**
PC67	Technical Adjustment to PC65 Mechanism	Technical adjustment that allowed the credit to be greater than the entry charges paid by an individual shipper	**Not vetoed**
PC75	NTS TO Commodity Charge	Introduction of an NTS TO Commodity charge (that may be negative) to supersede PC65 (compliment PC65 in final proposal)	**Vetoed**
PD17	Setting of NTS Transportation Charges	Consideration of whether the charging methodology is consistent with auction uncertainty	N/A
PC77	NTS TO Commodity Charge	Introduction of an NTS TO Commodity charge (that may be negative) as the primary over/under recovery mechanism with PC65/67 as the secondary mechanism	**Vetoed**
PC78	NTS TO Commodity Charge (NTS TO Under Recovery)	Introduction of an NTS TO commodity charge as a mechanism for dealing with the under recovery of NTS TO revenue only.	**Not vetoed**

3 Prevailing Methodology

3.1 If entry capacity auction implied revenue is anticipated to be more than 10% above the target auction revenue[1], the total excess auction revenue is divided into monthly amounts and is used to 'fund' the entry buy-back scheme.

3.2 This is achieved by way of credits (a reduction in entry capacity charges) for each month by the lower of the monthly excess and monthly buy-back cost.

3.3 These credits offset the costs of entry capacity buy-back that are borne by shippers through the capacity neutrality mechanism. The credits would be treated as payments to shippers under the Licence $TORCOM_t$ term.

3.4 Any excess amount (of auction revenue) remaining for any month is carried forward to the next month.

3.5 Any excess amount (of auction revenue) remaining at the end of the formula period would feed into the 'K' mechanism. Excess revenue from one formula period results in reduced allowed revenue in the following formula period.

Pricing Consultations PC65 PC67

3.6 The entry capacity buy-back offset mechanism was introduced in 2001 as a result of Pricing Consultation PC65. PC65 amended the transportation charging methodology such that :

- If auction implied revenue is above, but within 10% of, the target level, there will be no automatic offsetting adjustment to transportation charges;
- If auction implied revenue is more than 10% above the target level, National Grid NTS will calculate the level of this excess revenue;
- The excess revenue will then be divided by six[2] in order to establish monthly amounts;
- For any month where the excess amount exceeds aggregate User buy-back costs, the excess amount for the following month will be increased by the amount by which the excess exceeds aggregate User buy-back costs; and
- National Grid NTS will reduce each User's entry capacity charges by a share of the lower of the excess or buy-back costs for the relevant month, with that share based on the proportion of aggregate MSEC held by the User concerned in the relevant month, subject to that share not exceeding its unadjusted entry charge.

3.7 Pricing consultation PC67 resulted in the removal of the rule *"subject to that share not exceeding its unadjusted entry charge."*

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[1] Target Entry Capacity auction revenue is currently 50% of the TO allowed revenue remaining after DN pension charges have been deducted.

[2] At the time that PC65 was implemented, the mechanism would have been applied in the October with the knowledge of previous auction results.

4 Discussion and Issues

4.1 From 1st October 2007 the TO Entry Commodity charge rate will be set at or close to zero as a result of the revenue implied by the 2007 AMSEC auction and forecast revenue for the remaining rolling monthly NTS Entry Capacity (RMSEC) auctions. Actual revenue resulting from the remaining RMSEC auctions and TO revenue resulting from the TTSEC processes introduced through UNC Modification Proposal 0169 may result in TO Entry over recovery.

Issues Regarding the Prevailing TO Over Recovery Mechanism

4.2 The prevailing TO over recovery mechanism may result in credits being less than both the buy-back costs and the revenue over recovery in the period hence the process may be inefficient in redistributing excess revenue. This is largely due to the over recovery amount being divided by the remaining months within the formula period and the fact that credits are only paid against buy-back costs that occurred during or after the month in which over recovery has been identified. Buy-back costs from earlier in the formula year but prior to over-recovery being identified might not be included. E.g. what if buy-back costs are high in January but over-recover occurs in February?

4.3 The full over recovery amount could be available in the first month rather than dividing by the number of remaining months. Credits could also be made in relation to any buy-back costs incurred earlier within the formula year. These changes would increase the likelihood of credits being paid.

4.4 The prevailing methodology generates a credit up to the net buy-back cost. The net buy-back cost is the entry capacity neutrality cost which equates to the buy-back cost less daily capacity revenue and entry capacity over-run revenue. Limiting the credit to net buy-back costs might therefore limit the credit, and therefore limit the effectiveness of the mechanism, when there are daily capacity and or over-run revenues. Given that entry capacity neutrality can represent a credit to Users for days when there is daily capacity revenue and or entry capacity over-run revenue, it seems reasonable not to reduce the buy-back offset mechanism credit based on these revenues.

4.5 The Charging Methodology is unclear as to what happens if TO revenue over recovery is triggered by the RMSEC or any other auctions that may be introduced. This area of the Charging Methodology has not been revised since 2001 and hence an update based on revisions to the capacity regime over the intervening years should provide clarity and hence improve transparency.

4.6 Even if changes are made to the buy-back offset mechanism, there remains a risk that buy-back costs are less than the over recovery amount and hence the mechanism will not redistribute the full over recovery amount. In this scenario, excess revenue would flow into the ‘K’ mechanism. Excess revenue from one formula period result in reduced allowed revenue in the following formula period. This may lead to excess revenue collected from Entry Users being effectively redistributed on a fifty-fifty basis between Entry and Exit Users in the following formula period.

TO Entry Commodity Charge

4.7 Proposals have been raised in the past to introduce a negative TO Commodity charge to manage over recovery firstly to compliment the buy-back offset mechanism and secondly as a primary over recovery mechanism but both proposals were vetoed by the Authority. The difficulty with a negative commodity charge in combination with the buy-back offset mechanism is that both buy-back costs and over recovery revenue must be forecast to set the commodity rate and this is far from a simple or transparent process.

4.8 Even if appropriate forecasting processes could be defined there remains the scenario that over recovery is triggered at a time that does not allow a negative rate to be set within the formula year given the charge notice requirements within the Licence and the UNC.

4.9 The proposed amendment, contained within this consultation document, in respect of the TO Over Recovery Mechanism may not in practice redistribute the full over recovery amount (4.6 above). National Grid NTS will further investigate other options including the potential for introducing a negative TO Entry Commodity charge in order to reduce the risk of over recovery and will bring forward separate proposals.

4.10 The TO Entry Commodity charge has been set at a non-zero rate for the period April 2007 to September 2007. National Grid NTS recognise that the risk of TO over-recovery might be mitigated by setting a zero rate TO Commodity charge for the first six months of the formula period and hence will consider a return to charging for the winter period only.

Mechanism Trigger

4.11 The entry capacity buy-back offset mechanism is not triggered until over recovery is in excess of 10% of allowed revenue. This is not consistent with the National Grid Gas Transportation Licence in respect of the NTS which includes reasonable endeavours obligations not to over recover by more than 4% in any formula year and not to over recover by more than 6% over any two consecutive formula years.

4.12 The process could be triggered at any point during the formula year based on the outcome of any auction representing a TO revenue stream. Revenue from daily auctions is treated as SO revenue.

5 Terms of the Original Proposal

5.1 National Grid NTS proposed that:

Trigger

- The mechanism would be triggered if the revenue implied by NTS Entry Capacity auctions breached either the Licence obligation not to exceed the maximum NTS transportation owner revenue ($TOMR_t$) by more than 4% in any formula year or not to exceed the maximum NTS transportation owner revenue by more than 6% over any two formula years
- The process would be triggered at any point during the formula year based on the outcome of any NTS Entry Capacity auction other than the on the day auctions for daily capacity (DSEC) and daily interruptible capacity (DISEC).

Mechanism

- The full over recovery amount would be available in relation to the first month for which the mechanism was triggered
- Any residual over recovery at the end of the month would be rolled forward to the next month.
- Any residual over recovery at the end of the formula year would be used to offset buy-back costs in those months within the formula period when buy-back costs had occurred and no credit had been paid or where the credit was less than the buy-back cost (un-credited buy-back costs)
    - Where the residual over recovery is less than the aggregate un-credited buy-back costs,
        - Credits would be calculated for each month in proportion to the un-credited buy-back costs in each month.
    - Where the residual over recovery is equal to or greater than the aggregate un-credited buy-back costs,
        - Credits would be calculated for each month equal to the un-credited buy-back costs in each month.
- The credit would offset buy-back costs and hence daily capacity & over-run revenue could represent an additional credit through capacity neutrality

<u>Implementation</u>

5.2 It is proposed that these arrangements are implemented to define the TO Over Recovery Mechanism from 1st November 2007.

5.3 Credits would be paid following the month of over recovery e.g. if over recovery was identified in relation to capacity sold for November then, in the event that there were buy-back costs in November, a credit would be paid for November which would appear in the relevant capacity invoice.

6 Representations Made

National Grid NTS received 7 responses to its consultation on NTS GCM 09; all seven were in support. None of the responses were marked as confidential, and copies of the responses have been posted on the Gas Charging section of the National Grid information website.

Support for the Proposal

Respondent	Abbr.	View
EDF Energy plc.	EDF	Support
Scottish and Southern Energy plc	SSE	Support
E.ON UK plc	EON	Support
British Gas Trading	BGT	Support
RWE npower	RWE	Support
Statoil UK	STUK	Support
BG Gas Services Limited	BG	Support

Summary of Responses by Consultation Question

Q1. The mechanism trigger is linked to National Grid NTS's obligation not to exceed the maximum NTS transportation owner revenue (TOMRt) by more than 4% in any year and not to exceed the maximum NTS transportation owner revenue by more than 6% over any two consecutive formula years

<u>Respondents' Views</u>

STUK comments "Revising the trigger level by linking it directly to NGG NTS's licence obligation and triggering the process at any point during the formula year will result in more efficient allocation of credits paid to Users, associated with over-recovery."

RWE comments "The consultation document identifies a number of weaknesses with the current arrangements and we share National Grid's concerns. We endorse the proposed changes to the trigger and the rebating mechanism as set out in the document. These incremental changes will ensure that the delinking of bidding behaviour and revenue rebating is retained, which we think is important."

EDF comments "The current trigger of 10% does not align with NGG's licence conditions to not over recover revenue by more than 4% in a single formula period or by more than 6% over any two formula periods. Moving the trigger in line with these licence conditions would therefore appear appropriate. However given that NGG also aims to recover 50% of their TO revenue from entry charges, we would question why NGG has not chosen a trigger aligned with this objective? "

National Grid NTS' View

National Grid NTS continues to believe that setting the trigger directly to the Licence obligation not to over-recover TO revenue by more than 4% in a single formula period or by more than 6% over any two formula periods is the most appropriate approach. Maintaining the fifty-fifty split between entry and exit revenue could be achieved by managing the K mechanism separately for entry and exit revenue. In light of this response, however, it would seem most appropriate to define the over recovery amount as the difference between TO Entry revenue and the target TO Entry revenue.

Q2. The Process would be triggered at any point during the formula year

Respondents' Views

SSE notes "The proposal will ensure that where over-recovery occurs within a month, due to the RMSEC auction, the over recovery will first offset buy-back costs in that month before being used to offset buy-back costs at other times in the formula year."

National Grid NTS' View

National Grid NTS continues to believe that the mechanism should be triggered based on any auction that represents a TO revenue stream hence ensuring that over-recovery will first offset buy-back costs within the first month of over-recovery. This should maximise the effectiveness of the mechanism.

Q3. The full over recovery amount would be available in the first month of over recovery

Respondents' Views

STUK comments "Making the full recovery amount available in the first month, rather than by dividing it by the number of remaining months and calculating credits in relation to any buy-back costs incurred earlier within the year should increase the likelihood of credits being paid."

EDF comments "Making the full over recovery amount available to offset buy-backs from the month when the over recovery was triggered would reduce the chance of any over recovery remaining at the end of the formula year, whilst requiring Shippers to fund some of the buy-back costs due to the smear back calculations."

RWE comments that "increasing the extent to which any credits are repaid within a formula year means that these credits are targeted back to entry capacity holders, rather than split between entry and exit capacity via a K adjustment."

National Grid NTS' View

National Grid NTS continues to believe that making the full over recovery amount available to offset buy-back costs from the month when the over recovery was triggered should reduce the chance of any over recovery remaining at the end of the formula year and minimise the influence on User capacity bidding behaviour. This should maximise the effectiveness of the mechanism.

Q4. Credits would be paid based on monthly buy-back costs rather than 'net buy-back costs' (buy-back costs less over-run and daily capacity revenue) with daily capacity and over-run revenue potentially representing an additional credit

Respondents' Views

BGT "believes that the proposed modification will provide a better mechanism than the prevailing methodology by ensuring that in the relevant circumstances more excess revenue is returned to holders of NTS Entry Capacity than would currently occur."

National Grid NTS' View

Limiting the credit to net buy-back costs might limit the credit paid, and therefore limit the effectiveness of the mechanism, when there are daily capacity and or over-run revenues. Given that entry capacity neutrality can represent a credit to Users for days when there is daily capacity revenue and or entry capacity over-run revenue, National Grid NTS continues to believe that the buy-back offset mechanism credit should not be reduced based on these revenues.

Q5. Any remaining excess revenue would be rolled forward to the next month

Respondents' Views

SSE notes "The proposal will ensure that where over-recovery occurs within a month, due to the RMSEC auction, the over recovery will first offset buy-back costs in that month before being used to offset buy-back costs at other times in the formula year."

National Grid NTS' View

National Grid NTS notes that this aspect of the proposal is retained from the prevailing methodology but was included to ensure the clarity of the proposed mechanism.

Q6. Any remaining excess revenue at the end of the formula year would fund retrospective credits to offset buy-back costs earlier in the formula year

Respondents' Views

For the avoidance of doubt, RWE "would welcome conformation that any credits that are applied retrospectively to buy-backs undertaken before the trigger are apportioned on the same basis as original capacity holdings for that month."

EDF comments "Using any over recovery at the end of the formula period to credit Shippers for buy-back costs prior to the mechanism being triggered would also reduce the likelihood of any over recovery entering K at the end of the formula period."

National Grid NTS' View

National Grid NTS can clarify that that any credits that are applied retrospectively to buy-back costs incurred before the trigger would be apportioned on the same basis as original capacity holdings (i.e. MSEC holdings) for the relevant months.

Summary of Responses Regarding Relevant Objectives

STUK "supports this proposal as an incremental approach to resolve issues of over-recovery, ahead of this winter." STUK "agrees with National Grid Gas (NGG) NTS that the proposed changes to the Gas Transmission Transportation Methodology meet NGG's relevant GT licence objectives, as specified in the consultation document."

SSE "believes that the proposals contained in GCM09 would satisfy the relevant methodology objectives".

BG "is supportive of efforts to ensure that any TO Over recovery resulting from entry capacity auctions is refunded to those players who have, in aggregate, over paid for entry capacity. We recognise that care needs to be taken to avoid undesirable "feedback loops" where refunds of TO over-recovery simply result in higher bidding in entry capacity auctions resulting in further over-recovery. However we also believe it is necessary to avoid circumstances where over-recovery on entry can result in windfall gains for "downstream" players who receive refunds via the charging mechanism when over-runs are included in the "k" factor for the following year and therefore shared equally between entry and exit players."

EDF "support the concept that TO revenues should be collected 50% from entry and 50% from exit, and any over or under recoveries should also be targeted at those areas where they have arisen. The current mechanism for smearing any over recovery from entry capacity charges does not appear to facilitate this, and so exposes Shippers to the risk that any over recovery will not be smeared back to them directly."

<u>"Reflect the costs incurred by the licensee in its transportation business"</u>

SSE notes "In improving the efficiency of the process, the likelihood of over recovery is reduced and hence the aggregate charges would more closely reflect the costs incurred within the formula year."

<u>"Properly take account of developments in the transportation business"</u>

SSE notes "The proposal modifies the TO Over-recovery mechanism to take into account past and potential future changes to the NTS Entry Capacity regime and hence 'takes into account developments in the transportation business'."

RWE comments "There have been a number of developments in the entry capacity regime since the PC65 and PC67 mechanisms were introduced to manage auction over-recovery. Given the inherent volatility of using auctions to recover TO allowed revenues and National Grid's licence obligations regarding over and under recovery, it is appropriate to keep the TO over-recovery mechanism under review."

<u>"Facilitate effective competition between gas shippers and between gas suppliers"</u>

SSE notes "The proposal retains the principle that credits are paid in relation to capacity holdings and hence capacity revenue is returned to capacity holders without creating an incentive to procure more capacity than might otherwise have been the case."

EON "supports the proposals put forward by NG NTS in this consultation paper and believes they represent an improvement on the existing arrangements, by introducing more clarity and transparency."

Summary of Responses Regarding Further Proposals

<u>Entry Capacity Buy-back Costs</u>

STUK "recognises that this proposal may not, in practice, redistribute the full over recovery amount as buy-back costs may be less than the over-recovery amount. STUK, therefore, looks forward to discussing further, potential additional steps for addressing over-recovery."

RWE comments “National Grid also highlights potential additional developments to the mechanism and we believe that there is merit in considering these options further in the GTCMF. “

Negative Commodity Charge

BG “remain concerned that there could still be a TO over-recovery if the revenue received from entry capacity auctions exceeds the value of buybacks. Whilst we appreciate the difficulties of forecasting a negative TO commodity charge, we believe this could be solved by having a negative TO Commodity charge applied at the end of the year once all revenues were known. Further thought would need to be given to which periods in the year just finished the negative TO Commodity charge would apply to. However the main benefit would be that all flows and revenues for the preceding year would be known, thereby eliminating any forecasting uncertainties. BG is encouraged that NG is considering raising further proposals in this regard.”

EDF are “concerned with the suggestion that reducing the notice periods for any reductions in the TO Commodity charge could also ensure that costs were correctly targeted. Whilst we recognise that this is one option for targeting any over recovery, we are concerned that this concept could also be applied to increasing TO and SO Commodity charges. As an NTS Shipper we believe that stability and predictability of charges are equally important, and reducing the current notice period for these charges would introduce an additional risk that would ultimately be paid for by consumers.”

‘K’ Mechanism

BGT notes “that if buy-back costs during the formula year are lower than the over-recovery then the residual over-recovery will still feed into K and hence will adjust all TO gas transportation charges during the following year. BGT believes that excess revenue from NTS capacity auction should as far as possible be ‘ring-fenced’.”

BGT “supports implementation of GCM09 but suggests that further development of the methodology is required. There is still a possibility that the refund is not restricted to users of NTS Entry Capacity and more steps need to be taken in order to further reduce the amount of over-recovery feeding into K.”

EON comments that “there have been no buybacks to date since June/July 2006. In this case, as we understand it, there is no offsetting of over-recovery against buy-back costs and, as a result, the over-recovery amount is transferred into the calculation of “K” for the next formula year. Although we appreciate that this particular proposal does nothing to worsen or improve the current arrangements in this regard, we believe it is extremely important that all over-recovery should be redistributed within the same formula year and not carried over into calculation of “K”. We look forward to NG NTS bringing forward proposals to address this specific issue; for instance through a negative TO Commodity charge.”

National Grid NTS’ View

National Grid NTS recognises industry concerns regarding TO over recovery in light of recent changes to the entry capacity regime. GCM09 represents an incremental change to the prevailing arrangements and will not be fully effective in the scenario that entry capacity buy-back costs are less than the TO over-recovery amount. National Grid has committed to investigating the potential for further proposals to manage TO over-recovery in this scenario. A proposal to introduce a TO Entry Commodity rebate mechanism has been discussed at the Gas Transmission Charging Methodology Forum and will be raised shortly.

7 Changes to the Original Proposal in Light of Representations Made

7.1 As a result of representations received (see EDF response to Q1 in section 6), National Grid proposes that the following is added as the first step in the mechanism in addition to the proposal as set out in section 5 of this document.

- The over recovery amount will be calculated as the difference between TO Entry Revenue and TO Entry Target Revenue.

7.2 The following clarification is made in regard to the original proposal by National Grid NTS in consideration of representations received (see RWE response to Q6 in section 6).

7.3 For the avoidance of doubt, any credits that are applied retrospectively to buy-back costs incurred before the trigger are apportioned on the same basis as original capacity holdings for that month. For example if buy-back costs were incurred in October and the mechanism was triggered in November then any residual over-recovery remaining at the end of the year would be used to pay a credit against the October buy-back costs based on Users' October Capacity holdings.

8 Final Proposal

8.1 National Grid NTS proposes that:

Trigger

- The mechanism would be triggered if the revenue implied by NTS Entry Capacity auctions breached either the Licence obligation not to exceed the maximum NTS transportation owner revenue ($TOMR_t$) by more than 4% in any formula year or not to exceed the maximum NTS transportation owner revenue by more than 6% over any two formula years
- The process would be triggered at any point during the formula year based on the outcome of any NTS Entry Capacity auction that represented a TO revenue stream

Mechanism

- The over recovery amount will be calculated as the difference between TO Entry Revenue and TO Entry Target Revenue.
- The full over recovery amount would be available in relation to the first month for which the mechanism was triggered
- Any residual over recovery at the end of the month would be rolled forward to the next month.
- Any residual over recovery at the end of the formula year would be used to offset buy-back costs in those months within the formula period when buy-back costs had occurred and no credit had been paid or where the credit was less than the buy-back cost (un-credited buy-back costs)
  - Where the residual over recovery is less than the aggregate un-credited buy-back costs,
    - Credits would be calculated for each month in proportion to the un-credited buy-back costs in each month.
  - Where the residual over recovery is equal to or greater than the aggregate un-credited buy-back costs,
    - Credits would be calculated for each month equal to the un-credited buy-back costs in each month.
  - Credits in relation to un-credited buy-back costs in each month would be apportioned to each Shipper on the basis of its original capacity holdings for that month
- The credit would offset buy-back costs and hence daily capacity & over-run revenue could represent an additional credit through capacity neutrality

<u>Implementation</u>

8.2 It is proposed that these arrangements are implemented to define the TO Over Recovery Mechanism from 1st November 2007.

8.3 Credits would be paid following the month of over recovery e.g. if over recovery was identified in relation to capacity sold for November then, in the event that there were buy-back costs in November, a credit would be paid for November which would appear in the relevant capacity invoice.

9 How the Proposed Modification Achieves the Relevant Objectives

9.1 This section presents National Grid NTS's views in respect of the extent to which the proposal set out under section 8 would achieve the relevant methodology objectives under National Grid NTS's GT Licence and the EU Gas Regulations (as summarised under Appendix A).

9.2 The National Grid Gas plc Gas Transporter Licence in respect of the NTS requires that proposed changes to the Charging Methodology shall achieve the relevant methodology objectives.

Assessment against Licence Objectives

9.3 The National Grid plc Gas Transporter Licence in respect of the NTS requires that proposed changes to the Charging Methodology shall achieve the relevant methodology objectives.

9.4 Where transportation prices are not established through an auction, prices calculated in accordance with the methodology should:

- 1) Reflect the costs incurred by the licensee in its transportation business;
- 2) So far as is consistent with (1) properly take account of developments in the transportation business;
- 3) So far as is consistent with (1) and (2) facilitate effective competition between gas shippers and between gas suppliers.

9.5 National Grid NTS believes that the proposal contained in this report would satisfy the relevant objectives as, in improving the efficiency of the process, the likelihood of over recovery is reduced and hence the aggregate charges would more closely reflect the costs incurred within the formula year.

9.6 The proposal modifies the TO Over-recovery mechanism to take into account past and potential future changes to the NTS Entry Capacity regime and hence "takes into account developments in the transportation business".

9.7 The proposal retains the principle that credits are paid in relation to capacity holdings and hence capacity revenue is returned to capacity holders without creating an incentive to procure more capacity than might otherwise have been the case.

9.8 The proposal will ensure that where over-recovery occurs in relation to a month, for example due to the RMSEC auction, the over recovery will first offset buy-back costs in that month before being used to offset buy-back costs at other times in the formula year.

Assessment against EU Gas Regulations

9.9 EC Regulation 1775/2005 on conditions for access to the natural gas transmission networks (binding from 1 July 2006) states that the principles for network access tariffs or the methodologies used to calculate them shall:

- Be transparent
- Take into account the need for system integrity and its improvement
- Reflect actual costs incurred for an efficient and structurally comparable network operator
- Be applied in a non-discriminatory manner
- Facilitate efficient gas trade and competition
- Avoid cross-subsidies between network users
- Provide incentives for investment and maintaining or creating interoperability for transmission networks
- Not restrict market liquidity
- Not distort trade across borders of different transmission systems.

9.10 National Grid NTS believes that its charging proposal put forward in this paper is consistent with the principles listed above, specifically the amended methodology should;

- Be transparent
- Reflect actual costs incurred for an efficient and structurally comparable network operator
- Be applied in a non-discriminatory manner
- Avoid cross-subsidies between network users
- Not restrict market liquidity
- Not distort trade across borders of different transmission systems.

Appendix A – Examples

Example 1

This example assumes that over recovery is identified in October and there are no buy-back costs before October.

	All figures in £m		Oct	Nov	Dec	Jan	Feb	Mar	Total
A	Excess revenue from earlier auctions	A, data	£16.20						£16.20
B	RMSEC excess revenue for month	B, data	£0.00	£1.00	£2.00	£1.00	£2.00	£2.00	£8.00
C	Excess b/f from previous month	E=H from previous. month		£14.20	£11.20	£0.00	£0.00	£0.00	
D	Max rebate level for month	D= A+B+C	£16.20	£15.20	£13.20	£1.00	£2.00	£2.00	
E	Buy-back costs in month	E, data	£2.00	£4.00	£15.00	£2.00	£3.00	£1.00	£27.00
F	Credit for Month	F = Min(D,E)	**£2.00**	**£4.00**	**£13.20**	**£1.00**	**£2.00**	**£1.00**	£23.20
G	Un-credited buy-back cost	G=E-F	**£0.00**	**£0.00**	**£1.80**	**£1.00**	**£1.00**	**£0.00**	£3.80
H	Potential credit carried forward	H=D-F	£14.20	£11.20	£0.00	£0.00	£0.00	£1.00	
J	Additional retrospective Credit	Pro-rata H from March based on G	£0.00	£0.00	£0.47	£0.26	£0.26	£0.00	£1.00

Example 2

This example assumes that over recovery is identified in January and there are no buy-back costs before October however there are buy-back costs prior to over recovery being identified.

	All figures in £m		Oct	Nov	Dec	Jan	Feb	Mar	Total
A	Excess revenue from earlier auctions	A, data				£0.00			£0.00
B	RMSEC excess revenue for month	B, data				£3.00	£4.00	£2.00	£9.00
C	Excess b/f from previous month	E=H from previous. month				£0.00	£1.00	£2.00	
D	Max rebate level for month	D= A+B+C				£3.00	£5.00	£4.00	
E	Buy-back costs in month	E, data	£2.00	£4.00	£15.00	£2.00	£3.00	£1.00	£27.00
F	Credit for Month	F = Min(D,E)				**£2.00**	**£3.00**	**£1.00**	£6.00
G	Un-credited buy-back cost	G=E-F	**£2.00**	**£4.00**	**£15.00**	**£0.00**	**£0.00**	**£0.00**	£21.00
H	Potential credit carried forward	H=D-F	£0.00	£0.00	£0.00	£1.00	£2.00	£3.00	
J	Additional retrospective Credit	Pro-rata H from March based on G	£0.29	£0.57	£2.14	£0.00	£0.00	£0.00	£3.00