Promoting choice and value for all gas and electricity customers

Modification proposal:	**Modification Proposal NTS GCM 09 'TO Over Recovery Mechanism'**		
Decision:	**The Authority[1] has decided not to veto this proposal[2]**		
Target audience:	**NGG and other interested parties**		
Date of publication:	**23 October 2007**	Implementation Date:	**1 November 2007**

Background to the modification proposal

National Grid Gas (NGG) recovers its Transportation Owner (TO) allowed revenue equally through exit and entry charges. Entry capacity charges are levied on sales of entry capacity through various auctions. However, if the revenue through these auctions falls short of 50% of TO allowed revenue it is made up through TO entry commodity charges, which are estimated and levied by NGG. If revenue is in excess of 50% of TO allowed revenue the entry commodity charge cannot be negative and so an over-recovery mechanism is employed to refund excess payments by shippers for entry capacity.

Due to the high revenues implied by the 2007 Annual Monthly System Entry Capacity (AMSEC) auction the TO entry commodity charge has been set at zero from October 2007 to March 2008. However, revenue resulting from remaining Rolling Monthly System Entry Capacity (RMSEC) auctions or from Transfer and Trade System Entry Capacity (TTSEC) auctions could result in TO entry over recovery.

Currently, a TO entry over recovery is triggered if revenue exceeds the TO allowed revenue by 10%. In which case the excess of the auction revenue over the TO allowed revenue is divided by six to give the monthly excess amount. This monthly excess amount is used as a credit to offset the costs for the buy-back of capacity which are borne by shippers through the capacity neutrality mechanism. The costs of capacity buy-back are offset by the lower of the monthly excess amount or the monthly buy-back cost. Each user's entry capacity charges are then reduced by a share of this credit amount, with the share based on the proportion of aggregate monthly system entry capacity held by the user in the relevant month. Any excess at the end of the month (i.e. when the monthly excess amount is greater than the buy-back costs) is carried over to the next month and any excess at the end of the formula period feeds into the 'k' mechanism. The 'k' mechanism takes the revenue over recovery from one year applies interest and then subtracts this from the TO allowed revenue (which includes revenue from both entry and exit) in the following year.

The modification proposal ("the Proposal")

Through modification proposal NTS GCM 09 (TO Over Recovery Mechanism) NGG proposes a number of changes, these are that:

- the over-recovery mechanism is triggered if revenue implied by entry capacity auctions results in the TO actual revenue exceeding the TO allowed revenue by 4% in any formula year or by 6% over two formula years. The over recovery

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

amount would be calculated as the TO entry revenue less the TO entry allowed revenue;

- The full over recovery amount would be available in the month when the mechanism was triggered;
- Any residual over recovery at the end of the month is carried 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 in the formula year when buy-back had occurred but no credit had been paid or where the credit was less than the buy-back cost[3]; and
- The credits would offset buy-back costs, not net buy-back costs[4].

Credits in relation to un-credited buy-back costs in each month would still be redistributed to shippers according to the share of capacity holdings held by each shipper in that month. Also the mechanism for offsetting the cost of buy-back remains the same except that buy-back costs and not net buy-back costs are offset.

NGG proposes that GCM09 is implemented on 1 November 2007.

Justification of the modification proposal

NGG considers that NTS GCM 09 better achieves the relevant gas transmission transportation charging methodology objectives that:

- Compliance with the charging methodology results in charges which reflect costs incurred by the licensee in its transportation business
- the charging methodology properly takes account of developments in the transportation business
- compliance with the charging methodology facilitates effective competition between gas shippers and between gas suppliers

Responses to NTS GCM 09

NGG consulted on the proposals in August and September 2007 and received seven responses. All respondents supported implementation of GCM09.

Generally the respondents were supportive of changing the trigger mechanism proposed in GCM09, however, one respondent asks that as 50% of TO revenue comes from entry why NGG has not chosen a trigger aligned with this objective. NGG's final proposals deal with this point by stating that the over recovery amount is the difference between the TO entry revenue and the TO entry allowed revenue.

The move to make all over recovery available in the first month it is triggered and to offset capacity buy-back in the whole year with any over recovery still outstanding at the end of the year are seen as positive steps in moving towards better cost recovery. This is due to less over recovery from entry users being distributed through the 'k' mechanism to both entry and exit users in the following year. However, there are concerns that

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[3] Where residual over recovery at end of period is less than the aggregated un-credited buy-back costs the credits would be calculated for each month in proportion to the un-credited buy-back costs in each month. Where residual over recovery at end of period is greater than or equal to aggregated un-credited buy-back costs the credits for each month would be equal to the un-credited buy-back costs in each month.

[4] 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.

GCM09 would still result in over recovery being re-distributed to exit users in the following year if buy-back costs are less than the amount over recovered in the year.

Respondents are keen to see other options discussed, investigated and further proposals made. NGG notes that this GCM09 is the first in a number of proposals addressing the over recovery mechanism and further proposals will follow.

The Authority's decision

The Authority has considered the issues raised by the modification proposal and the Conclusions Report dated 1 October 2007. The Authority has considered and taken into account the responses[5] to NGG's consultation. The Authority has concluded that:

1. **implementation of the modification proposal will better facilitate the achievement of the relevant objectives of the Methodology[6]; and**
2. **deciding not to veto the proposal is consistent with the Authority's principal objective and statutory duties[7].**

Reasons for the Authority's decision

SSC A5(5)(a) save in so far as paragraphs (aa) or (d) apply, that compliance with the charging methodology results in charges which reflect costs incurred by the licensee in its transportation business

Ofgem considers that GCM09 has the potential to improve cost reflectivity through better targeting of the redistribution of this over recovery to the time periods when the over recovery was incurred and to the parties contributing to the over recovery amount.

Ofgem is of the view that making all excess revenue available to offset the costs of buy-back in the month when the over recovery is triggered better targets the redistribution of the over recovery amount to the time period when it is incurred. Furthermore, by using any over recovery remaining at the end of the target year to offset un-credited buy-back costs in the year better targets the redistribution of the over recovered amount to the year in which it was incurred. As currently the over recovery amount at the end of the year feeds into reducing the TO allowed revenue in the following year via the 'k' factor.

Additionally, this potential for reduced reliance on the 'k' factor should target the redistribution of the over recovery better at those users which contributed to the over recovery amount. This is because reduced reliance on redistributing the over recovery via the 'k' factor would mean that over recovery paid by NTS entry capacity users would not contribute to lower charges levied on both NTS entry and exit users in the following year.

SSC A5(5)(b) that, so far is consistent with sub-paragraph (a), the charging methodology properly takes account of developments in the transportation business

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[5] NGG modification proposals, modification reports and representations can be viewed on the NGG website at www.nationalgrid.com
[6] 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
[7]The Authority's statutory duties are wider than matters which the Panel must take into consideration and are detailed mainly in the Gas Act 1986.

Ofgem considers that moving to a trigger where the TO actual revenue exceeds the TO allowed revenue by 4% in any formula year or by 6% over two formula years takes into account the actuality of what NGG's obligations are regarding over recovered revenue as set out in its gas transporter licence.

Furthermore, Ofgem is of the view that having the potential for the over recovery mechanism to be triggered in any month better reflects the possibility that revenue over recovery could be triggered in the RMSEC auctions (which take place monthly) or TTSEC auctions (which took place in September and October 2007).

Ofgem expects NGG to keep its gas transmission transportation charging methodology under review so that the relevant methodology objectives are achieved, especially in light of any over or under recovery.

Decision notice

In accordance with Standard Special Condition A5 of NGG's Gas Transportation Licence, the Authority has decided not to veto modification proposal GCM09: TO Over Recovery Mechanism.

Robert Hull
Director, Transmission

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