nationalgrid

CONCLUSIONS REPORT TO THE AUTHORITY

Modification Proposals to the Gas Transmission Transportation Charging Methodology

NTS GCM 10:

TO Entry Commodity Rebate Mechanism

11th January 2008

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1 Executive Summary

This document sets out final proposals for amending the Gas Transmission Transportation Charging Methodology (the "Charging Methodology") in respect of the introduction of a TO Entry Commodity Rebate Mechanism which might be triggered in the event of TO revenue over recovery. This follows the completion of a 28 day consultation on Consultation Paper NTS GCM 10. This document is issued by National Grid in its' role as holder of the Gas Transporter Licence in respect of the NTS ("National Grid").

From 1st October 2007 the TO Entry Commodity charge rate has been set at zero as a result of the revenue implied[1] by the 2007 AMSEC auction and forecast revenue from the remaining rolling monthly NTS Entry Capacity (RMSEC) auctions. Actual revenue from the remaining RMSEC auctions and the £13.4M of revenue resulting from the Entry Capacity Trade & Transfer processes, introduced through UNC Modification Proposals 0169, will result in TO Entry over recovery.

In the event of TO over recovery, the prevailing TO over recovery mechanism leads to a credit being paid to all Users based on their Monthly System Entry Capacity (MSEC) holdings to offset NTS Entry Capacity buy-back costs. NTS Entry Capacity buy-back costs represent a cost to Users via the Entry Capacity Neutrality charge. Revisions to this mechanism to increase its efficiency have been introduced through Charging Proposal NTS GCM 09, however, in the event that buy-back costs are less than the over recovery amount, this mechanism will not redistribute the full over recovery amount.

The TO Entry Commodity charge had been set at 0.0120 p/kWh from 1st April 2007 to 31st September 2007. This rate had been determined from forecast TO allowed revenue less implied revenue from earlier auctions and forecast revenue from the RMSEC and AMSEC auctions within the period and collected approximately £46.7m. The forecast revenue from these auctions had been based on historical bidding behaviour however prices paid were significantly higher than anticipated due to a combination of constraints, entry baseline capacity changes and the anticipated trade and transfer processes. A non-zero rate had also been applied from the April of a formula year due to industry concerns about price stability; previously a non-zero rate had only been applied in the October to March period.

With hindsight the TO Entry Commodity charge would have been set at a lower rate and hence a rebate to this charge could be used to manage any residual over recovery should the level of buy-back costs lead to the buy-back offset mechanism not being fully effective.

GCM10: National Grid proposes through this document that:

Trigger

- The TO Entry Commodity rebate mechanism would be triggered if there remained a residual over recovery amount after taking into account any revenue redistributed by the buy-back offset mechanism (as described in GCM09)
- The mechanism would be triggered even if the buy-back offset mechanism had not been triggered

[1] Revenue from the entry capacity auctions is invoiced after the applicable month.

- The mechanism would be triggered at the end of the formula year based on the outcome of all NTS Entry Capacity auctions that represent a TO revenue stream.

Mechanism

- As specified by GCM09, any residual over recovery at the end of the formula year would first 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
- Any residual revenue remaining after this process would be available as a credit to shippers i.e. remaining over recovery amount calculated after taking into account any payments resulting from the buy-back offset mechanism
- Credits would only be paid if the residual over recovery was in excess of £1m (this equates to the minimum TO Entry Commodity price of 0.0001 p/kWh)
- The ratio of the remaining TO over recovery amount and the TO Entry Commodity Revenue paid (April 07 to September 07 only for the 2007/8 formula year) would be calculated
- The ratio would be capped at 1 i.e. only rebate TO Entry Commodity revenue received
- Rebate of TO Entry Commodity charges paid earlier in formula year based on the ratio
- Rebate paid in April following formula year i.e. April 2008 invoice for the current formula year

Implementation

It is proposed that these arrangements are implemented to amend the TO over recovery mechanism from 1st March 2008.

Example

To date the implied TO over recovery for 2007/8, based on a forecast of future RMSEC revenue, is £12.35m with £46.7m having been collected through the TO Entry Commodity charge. A rebate of 26.4% of TO Entry Commodity charges would therefore clear the TO over recovery amount. An example based on similar data is shown in Appendix B.

Future Proposals

This proposal represents the next step in addressing TO entry over recovery following on from the implementation of GCM09. Further proposals would be required to address the scenario where both the buy-back offset mechanism, as revised through GCM09, and the TO Entry Commodity Rebate Mechanism, as described in this proposal, were ineffective in managing over recovery. This would be the case if TO over recovery, after taking into account the buy-back offset mechanism, was in excess of revenue recovered through the TO Entry Commodity charge. To date the implied TO over recovery is £12.35M with £46.7M having been collected through the TO Entry Commodity charge and hence the proposed mechanism being ineffective is highly unlikely to be the case for the 2007/8 formula year.

2 Introduction

2.1 From 1st October 2007 the TO Entry Commodity charge rate has been set at zero as a result of the revenue implied by the 2007 AMSEC auction and forecast revenue from the remaining rolling monthly NTS Entry Capacity (RMSEC) auctions. Actual revenue from the remaining RMSEC auctions and the £13.4m of revenue resulting from the Entry Capacity Trade & Transfer processes, introduced through UNC Modification Proposals 0169, will result in TO Entry over recovery.

2.2 The prevailing TO over recovery mechanism leads to a credit being paid to all Users based on their Monthly System Entry Capacity (MSEC) holdings to offset NTS Entry Capacity buy-back costs. NTS Entry Capacity buy-back costs represent a cost to Users via the Entry Capacity Neutrality charge. Revisions to this mechanism to increase its efficiency have been introduced through Charging Proposal NTS GCM 09, however, in the event that buy-back costs are less than the over recovery amount, this mechanism will not redistribute the full over recovery amount.

2.3 The TO Entry Commodity charge had been set at 0.0120 p/kWh from 1st April 2007 to 31st September 2007. This rate had been determined from forecast TO allowed revenue less implied revenue from earlier auctions and forecast revenue from the RMSEC and AMSEC auctions within the period and collected approximately £46.7m. The forecast revenue from these auctions had been based on historical bidding behaviour however prices paid were significantly higher than anticipated due to a combination of constraints, entry baseline capacity changes and the anticipated trade and transfer processes. A non-zero rate had been applied from the April of this formula year in response to industry concerns about price stability; previously a non-zero rate had only been applied in the October to March period.

3 Background

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

3.2 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.

3.3 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.

4 Discussion and Issues

Issues Regarding the Prevailing TO Over Recovery Mechanism

4.1 The prevailing TO over recovery mechanism involves the payment of credits to shippers, based on their capacity holdings, which offsets their exposure to entry capacity buy-back costs. Entry capacity buy-back costs represent a cost to shippers via the capacity neutrality arrangements.

4.2 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 results 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

4.3 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 history of revenue over recovery mechanisms is outlined in appendix A.

4.4 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. This appears to have been the key to the Authority's rejection of previous proposals.

4.5 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. These issues could largely be addressed by applying the charge retrospectively.

4.6 The TO Entry Commodity charge has been set at a non-zero rate for the period April 2007 to September 2007. National Grid 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 i.e. applying a zero TO Entry Commodity rate for the first six months of the formula year.

TO Entry Commodity Charge Rebate

4.7 The TO Entry Commodity charge had been set at 0.0120 p/kWh from 1st April 2007 to 30th September 2007. This rate had been determined from forecast TO allowed revenue less implied revenue from earlier auctions and forecast revenue from the RMSEC and AMSEC auctions within the period and collected approximately £46.7m.

4.8 With hindsight the TO Entry Commodity charge may have been set at a lower rate and hence a rebate to this charge could be used to manage any residual over recovery should the level of buy-back costs lead to the buy-back offset mechanism not being fully effective in managing any over recovery. To date there have been no buy-back costs.

Mechanism Trigger

4.9 The entry capacity buy-back offset mechanism is not triggered until implied over-recovery is more than 4% in the formula year or more than 6% over the current and previous formula years.

4.10 The trigger for the buy-back offset mechanism exists largely to stop both the buy-back offset mechanism and a non-zero TO Entry Commodity charge applying simultaneously. Such a trigger would not be required for any retrospective TO Entry Commodity charge rebate.

4.11 A rebate of TO Entry Commodity charges would represent retrospectively resetting the TO Entry Commodity rate to a lower level. Credits might only be paid if the residual over recovery was in excess of £1M as this equates to the minimum TO Entry Commodity price of 0.0001 p/kWh i.e. an aggregate credit of £1m would represent a 0.0001 p/kWh reduction to the TO Entry Commodity rate.

4.12 The rebate process could be triggered at the end of the formula year based on the outcome of all auctions representing a TO revenue stream, TO Entry commodity revenue and any credits paid as a result of the buy-back offset mechanism. Revenue from daily auctions would continue to be treated as SO revenue.

Example

4.13 To date the implied TO over-recovery for 2007/8, based on a forecast of future RMSEC revenue, is £12.35m with £46.7m having been collected through the TO Entry Commodity charge. A rebate of 26.4% of TO Entry Commodity charges would therefore clear the TO over recovery amount.

Future Proposals

4.14 The introduction of a TO Entry Commodity rebate would represents the next step in addressing TO Entry over recovery following on from the implementation of GCM09. Further proposals would be required to address the scenario that both the buy-back offset mechanism, as revised through GCM09, and a TO Entry Commodity Rebate Mechanism, were ineffective in managing TO over recovery. This would occur if the level of over recovery, after taking into account buy-back offset credits, was in excess of TO Entry Commodity revenue. To date the implied TO Exit over recovery is £12.35m with £46.7m having been collected through the TO Entry Commodity charge and hence the proposed mechanism being ineffective is highly unlikely to be the case for the 2007/8 formula year.

4.15 A potential next step in addressing TO Entry over recovery could be through applying a negative TO Entry Commodity charge retrospectively across the formula year as proposed in GCM11.

5 Terms of the Original Proposal

5.1 National Grid proposed that:

Trigger

- The TO Entry Commodity rebate mechanism would be triggered if there remained residual over recovery amount after taking into account any revenue redistributed by the buy-back offset mechanism
- The process would be triggered at the end of the formula year based on the outcome of all NTS Entry Capacity auctions that represent a TO revenue stream.

Mechanism

- As specified by GCM09, any residual over recovery at the end of the formula year would first 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
- Any residual over recovery revenue, taking into account any payments resulting from the buy-back offset process, would be available as a rebate to shippers
- Credits would only be paid if the residual over recovery was in excess of £1M (this equates to the minimum TO Entry Commodity price of 0.0001 p/kWh)
- The ratio of the remaining TO over recovery amount and the TO Entry Commodity Revenue paid (April 07 to September 07 for the 2007/8 formula year) would be calculated
- The ratio would be capped at 1 i.e. only rebate TO Entry Commodity revenue received
- Rebate of TO Entry Commodity charges paid based on ratio
- Rebate paid via April invoice following formula year i.e. April 2008 invoice for the current formula year

<u>Implementation</u>

It was proposed that these arrangements are implemented from 1st March 2008 to compliment the existing TO over-recovery buy-back offset mechanism.

6 Representations Made

National Grid NTS received [9] responses to its consultation on NTS GCM 10; [7] were in support and [2] were not 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[2].

Support for the Proposal

Respondent	Abbr.	View
Scottish and Southern Energy plc	SSE	Support
E.ON UK plc	EON	Support
RWE npower	RWE	Support
Statoil UK	STUK	Support
BG Gas Services Limited	BG	Support
Exxonmobil	EXM	Support
Shell Gas Direct Ltd	SGD	Support
British Gas Trading	BGT	Not in support
EDF Energy plc.	EDF	Not in support

Summary of Responses by Consultation Question

Q1. The TO Entry Commodity rebate mechanism would be triggered if there remained a residual over recovery amount after taking into account any revenue redistributed by the buy-back offset mechanism.

Q2. The process would be triggered at the end of the formula year based on the outcome of all NTS Entry Capacity auctions that represent a TO revenue stream.

<u>Respondents' Views</u>

BGT "believes that the current methodology does need to be modified in order to ensure that in the relevant circumstances more excess revenue is returned to holders of NTS Entry Capacity than would currently occur. BGT believes that excess revenue from NTS capacity auctions should as far as possible be 'ring-fenced' to NTS Entry charges."

[2] GCM10 consultation responses can be found at ;

http://www.nationalgrid.com/uk/Gas/Charges/consultations/

RWE “support the approach set out under GCM10 and agree that it represents a positive additional step towards addressing the acknowledged weaknesses in the current arrangements. It recognises that, in practice, the current mechanism will not redistribute the full over recovery where buy-back costs are lower than the over recovery amount. In this case, any residual over recovery will feed into K and adjust all TO gas transportation charges during the following formula year. We believe that this residual amount should be targeted back to entry capacity holders and that the GCM10 methodology is an appropriate mechanism to achieve this. In particular, we endorse the definitions of the trigger and the mechanism itself.”

National Grid’s View

National Grid agrees that the current methodology does need to be modified in order to ensure that in the relevant circumstances more excess revenue is returned to holders of NTS Entry Capacity than would currently occur. National Grid believes that this proposal represents an improvement to the existing Charging Methodology as it ensures that excess revenue from NTS capacity auctions is, as far as possible, ‘ring-fenced’ to NTS Entry charges, without influencing future capacity bidding behaviour.

Q3. Credits would only be paid if the residual over recovery was in excess of £1m (this equates to the minimum TO Entry Commodity price of 0.0001 p/kWh)

Respondents’ Views

EXM “support the first two trigger mechanisms but do not support the third trigger which allows credits to be paid only when the residual over recovery is in excess of £1m. Whilst we believe that it is sensible to have a threshold below which payments would not be made, we believe this limit is too high and we would therefore ask National Grid to reconsider this point.”

National Grid’s View

National Grid believes that a threshold is appropriate as costs may be incurred in redistributing small amounts of revenue and National Grid believes that it would be inappropriate to propose an arbitrary number for this threshold.

The £1m threshold was based on the lowest level of granularity for the TO Entry Commodity Charge of 0.0001 p/kWh over the year i.e. annual throughput *0.0001 p/kWh ~ £1M. This should therefore make the likelihood and magnitude of entry over recovery more consistent with exit.

Given that there is a cost associated with operating the process, National Grid continues to believe that the existence and level of the threshold is appropriate. It is important to remember that the full over recovery amount would be redistributed and not the amount above the threshold.

Mechanism

Q4. Any residual revenue over recovery amount, calculated after taking into account any payments resulting from the buy-back offset mechanism, would be available as a rebate to shippers.

Respondents' Views

BG "supports GCM 10 on the basis that it enables refund of TO Over recovery in the event that GCM 09 proves insufficient. However I note that there could still be circumstances in which an Over Recovery exceeds the mechanisms provided by both GCM 09 and GCM 10. BG therefore welcomes further proposals that attempt to address this issue."

National Grid's View

National Grid recognises that it is highly unlikely that GCM09 and GCM10 would be insufficient to manage any potential TO Entry revenue over recovery within the 2007-8 formula year, however this may not be the case in subsequent formula years and National Grid has raised charging proposal GCM11 "Retrospective Negative TO Entry Commodity Charge" to seek to further improve the NTS Charging Methodology.

Q5. Ratio of remaining over recovery amount and TO Entry Commodity Revenue paid (April 07 to September 07) Calculated, capped at 1 i.e. only rebate TO Entry Commodity revenue received.

Respondents' Views

BGT comments "GCM 10 has failed to recognise that the over-recovery has resulted from auctions relating to the whole formula year and not only the months for which a TO commodity charge has been applied. BGT therefore does not support implementation of either GCM 10 or GCM 11 but suggests that further development of the methodology is required in order to apply a rebate to all gas which enters the NTS during the whole formula year."

National Grid's View

GCM10 proposes a rebate of TO Entry Commodity charges paid given hindsight of auction results. The TO Entry Commodity charge had been set at 0.0120 p/kWh from 1st April 2007 to 31st September 2007. This rate had been determined from forecast TO allowed revenue less implied revenue from earlier auctions and forecast revenue from the RMSEC and AMSEC auctions within the entire formula year. The forecast revenue from these auctions had been based on historical bidding behaviour however prices paid were significantly higher than anticipated due to a combination of constraints, entry baseline capacity changes and the anticipated trade and transfer processes. As a consequence of this implied revenue, a zero TO Entry Commodity rate was set for the winter period.. To redistribute revenue over the winter period as well as the summer period would be inequitable. National Grid has proposed rebates of the charges paid as these would have been lower with perfect foresight of auction behaviour.

Q6. Rebate of TO Entry Commodity charges paid, based on ratio, in April following formula year i.e. April 2008 invoice for the current formula year.

Respondents' Views – Optional "Short-Haul" Commodity Charge

BGT comments that GCM10 has "failed to take into account entry capacity for gas which enters the system but uses the NTS Optional Commodity Charge rather than TO and SO commodity charges"

National Grid's View

National Grid believes that it is not appropriate for flows that avoid under-recovery charges (e.g. short-haul avoids the TO Entry Commodity charge) to benefit from over recovery payments as this would be discriminatory. If those flows which currently avoid the TO Entry Commodity charge (Storage and Short-haul) were to attract the TO Entry Commodity charge in the future then they would receive a rebate under the GCM10 proposed mechanism.

Implementation

Q7. These arrangements are implemented to add to the TO Over Recovery Mechanism from 1st March 2008.

Respondents' Views - Interest

BGT comments "payment of interest should occur in relation to money which has been held by National Grid."

National Grid's View

The current implied TO revenue over recovery of £12.46m would not actually occur until March although National Grid may make over recovery payments through the GCM09 entry capacity buy-back offset mechanism before that date. Given that the over recovery rebates proposed through GCM10 would be linked to the March invoice, National Grid would at no point in the 2007/8 formula year have received more than its TO allowed revenue were either charging proposal to be implemented. There is also no mechanism within the licence to cater for within formula year interest. The introduction of such a mechanism to manage credits or charges would be anticipated to add significant complexity to cater for an extremely unlikely scenario based on experience from this formula year.

Additional Discussion Questions

Q8. Should the TO Commodity Charge be set to zero between April and September of each formula year?

Respondents' Views

EXM "is generally in support of stable and predictable pricing and we do not think it is appropriate to set the commodity price to zero for the period April to September. We understand that the nature of the capacity auction process makes the prediction of TO capacity revenues difficult and consequently makes it hard to set the appropriate TO commodity charge on an annual basis. By setting the commodity charge twice a year (April & October) National Grid should be better able to forecast the appropriate recovery level."

National Grid's View

A non-zero rate had been applied from the April of this formula year in response to industry concerns about price stability; previously a non-zero rate had only been applied in the October to March period. National Grid has published an indicative rate for the TO Entry Commodity charge of 0.0019 p/kWh for 1st April 2008 based on auction experience (an 84% reduction from the 1st April 2007 rate) to seek to set more stable charges.

Q9. Should National Grid consider raising a separate proposal to introduce a symmetrical methodology i.e. to have a final payment to manage either over or under recovery?

Respondents' Views

EXM comments "A symmetrical methodology for over or under recovery would be easier to understand and might help to smooth out the fluctuations in the commodity rate."

EDF comments "Under NGG's Licence they have a licence condition to provide 150 days notice of indicative charges and 2 months notice of final charges. Whilst this proposal is offering a rebate on over recovered revenue from the TO Commodity charge, in effect this is retrospectively reducing the TO Commodity charge. It could therefore be argued that as this proposal is resetting charges, albeit retrospectively, then NGG would be required to provide the notice for charge changes as dictated in the licence. However NGG are not proposing this level of notice."

EDF "has often stated that it believes that predictability of charges is imperative to ensure the continued success of the UK gas market, followed closely by stability of charges. However this proposal does not provide predictability as the charges paid during the year may not be representative of the final charges that were actually paid, and would provide little transparency as to what level charges would be. Whilst we recognise the opportunity that this proposal represents for Shippers who have over funded NGG's revenue, we are particularly concerned on the precedent that this proposal sets. In particular by accepting the principle that any over recovery of revenue can be refunded with little or no notice, the industry would also be accepting that any under recovery of revenue could be collected with little or no notice. We do not believe that this would be beneficial to the industry, and would represent an increase in the Shippers' risk premium that would ultimately be paid for by consumers."

National Grid's View

GCM10 proposes a rebate and therefore does not represent a charge. Having further considered the notice requirements within the Licence, National Grid believes that charges could not be set retrospectively only rebates. Rebates were introduced via PC65 and the principle of continuing to provide rebates without explicit notice through the entry capacity buy-back offset mechanism has been supported by the implementation of GCM09. National Grid recognises the risk to shippers that the introduction of retrospective charging would create and hence has no intention of proposing retrospective charging.

Summary of Responses by Relevant Objectives

Reflect the Cost Incurred by the Licensee

SGD “would also argue that given the impact of GCM10 on the subsequent accuracy and appropriateness of the TO Entry Commodity Charge, it is in line with NGG’s licence objectives to have charges reflective of costs incurred in its transportation business.”

SSE believes “In improving the efficiency of the TO Entry Commodity process, the likelihood of over recovery is reduced and hence the aggregate charges would more closely reflect the costs incurred within the formula year.”

STUK “support the introduction of GCM10. STUK agrees with National Grid Gas (NGG) NTS that the proposed changes to the Gas Transmission Transportation Methodology meet NGG’s licence objectives to reflect the costs incurred in its transportation business. The rebate mechanism will ensure that the level of TO Entry Commodity charge levied on a shippers business more accurately reflects the level of recovery achieved by the Transporter through the entry capacity auction process.”

EON ”welcome any measures which seek to avoid the over recovery amount being transferred into the calculation of “K” for the next formula year. We believe it is extremely important that all over recovery should be redistributed within the same formula year.”

EDF “supports the principle of cost reflective charging, and further believes that it is appropriate that 50% of TO Revenue is recovered from entry capacity. We also believe that it is appropriate that a mechanism is developed to ensure that any over, or under recovery of revenue is targeted at the correct part of the market.”

EDF “believes that a more equitable solution would be to develop the charging methodology so that any contribution to “k” from either the entry or exit regime would be retargeted at the contributing regime in the following year. I.e. any over recovery from entry charges in one year would be used to offset entry charges in the following year. This would ensure that revenue and charges are recovered from the appropriate market segment, and so ensure that charges are reflective of the costs imposed on the system. This would avoid the risk of cross subsidisation across regimes and so would not be detrimental to competition between Shippers. Finally this would ensure that NGG continued to provide the notice requirements as laid down in its licence conditions and would not create the risk of retrospective charges being levied on Shippers.”

Take Account of Developments in the Transportation Business

SSE believes “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”.

BG ”also continue to be concerned that there is insufficient “joined up thinking” by NG and Ofgem in the design of the entry capacity and charging regimes.” As NG notes in the GCM 10 consultation:

“The forecast revenue from these auctions had been based on historical bidding behaviour; however prices paid were significantly higher than anticipated due to a combination of entry baseline capacity changes and the anticipated trade and transfer processes.”

BG notes "This comment clearly illustrates that changes to the entry capacity regime can have an impact on the stability of the charging regime. However the converse is also true, namely the structure of charges will impact shippers' bidding behaviour and hence the signals NG receives about demand for entry capacity. I would ask that NG and Ofgem bear these interactions in mind when designing and approving both the charging and entry capacity regimes."

Facilitate Effective Competition

SGD "considers it important that costs and revenues are targeted and allocated as accurately as possible as, in broad terms, this would normally be argued to be good for competition; In this particular instance, GCM10 should be supported as it would limit the redistribution of excess auction revenues to the relevant parties, ie. those who have participated in the entry capacity auctions; and, as such GCM10 should help promote competition between shippers."

STUK comment "If GCM10 is not introduced then any over recovery in the entry capacity auctions that is not captured by the GCM09 process would be captured by the general smearing mechanism. As this is not targeted the net effect would be the misallocation of costs between shippers active upstream and downstream of the NBP. It could be argued therefore that GCM10 furthers the objective of securing effective competition between shippers."

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

Entry v Exit Arrangements

EDF "support the objective of this proposal, however we believe that this proposal is discriminatory, is in contradiction to National Grid Gas' (NGG's) Gas Transporter Licence and would be detrimental to competition between Shippers

EDF "recognise NGG's desire to have this mechanism in place for this year to ensure that they meet their revenue targets, and to ensure that any over recovery is redistributed to the market segment from where it originated. However whilst the mechanism for this presented in GCM10 represents an equitable solution for these specific circumstances, we do not believe that it represents an enduring solution and sets a worrying precedent."

EDF note "that this proposal has been raised to ensure that the over recovery that is forecast for the current formula period is returned to the entry capacity participants who have funded this. However this proposal only deals with over recoveries and not under recoveries and so could be viewed as discriminatory. Under the current arrangements any over or under recoveries of allowed revenue at the end of the formula period enters the "k" calculation, which is used to calculate the allowed revenue for the formula period, and so is smeared across both entry and exit. This proposal therefore suggests that whilst it not acceptable to smear any over recoveries between entry and exit, it is acceptable to smear any under recoveries. This is not cost reflective, could be viewed as discriminating between entry and exit markets and would have a detrimental impact on competition between Shippers."

EDF comments “For Shippers operating within the exit segment of the market, exit capacity charges are derived on an administered basis to ensure that 50% of TO revenue is recovered from the exit regime. As this sector is not exposed to the volatility, and uncertainty associated with auctions, it would appear that revenues from this sector normally come in on target. This therefore ensures that the charges applied, and the revenues collected from this segment of the market are reflective of the costs that that these participants place on the system (assuming that the current charging methodology for determining these charges is cost reflective). However under GCM10, any under recovery from the entry regime would be smeared the following year over both the entry and exit regimes. Therefore the charges applied, and the revenues collected from the entry regime would not reflect the costs that this market placed on the system. As such therefore that in instances of entry revenue under recovery it could be viewed that the exit regime was cross subsidising the entry regime. This would therefore favour Shippers who operated in the entry regime against Shippers who only operated in the exit regime and would therefore be detrimental to competition.”

<u>National Grid’s View</u>

National Grid continues to believe that the GCM10 proposal achieves the relevant Licence objectives and welcomes all support for the proposal.

In relation to the comments from EDF, National Grid notes that currently there is a significantly greater risk of high magnitude Entry over recovery compared to Entry under-recovery or exit under or over recovery. GCM10 is attempting to address this discrepancy.

<table>
<tr><th>Risk</th><th>Mitigation</th><th>Risk mitigated?</th></tr>
<tr><td>TO Exit Under-recovery</td><td rowspan="2">TO Exit revenue recovery is achieved completely via administered capacity prices and hence there is no risk related to auction behaviour or throughput variability linked to weather risk.</td><td>✓</td></tr>
<tr><td>TO Exit Over recovery</td><td>✓</td></tr>
<tr><td>TO Entry Under-recovery</td><td>Entry auction reserve prices and the TO Entry Commodity charge limit the potential for significant under recovery</td><td>✓</td></tr>
<tr><td>TO Entry Over recovery</td><td>The buy-back offset mechanism, introduced via PC65 and modified via GCM09, provides some protection against TO entry over recovery. This will not be fully effective if the implied over recovery revenue is in excess of buy-back costs.</td><td>✗</td></tr>
</table>

National Grid does not see this objection, i.e. that similar arrangements should exist for entry under recovery and exit over and under recovery, as a reason not to progress the GCM10 proposal as it is seeking to reduce the disparity between the likelihood of over recovery of entry, and exit revenue.

In regard to the comments suggesting separate management for entry and exit of the Licence defined over and under recovery mechanism (the ‘K’ mechanism) , National Grid has identified a number of potential options for managing K separately for entry and exit revenue for charge setting purposes. These options were presented at the December 2007 Gas TCMF. The consensus of the meeting was that such a proposal would make only small adjustments to the charge setting process and these would actually increase rather than decrease price stability. Such a proposal would also not ensure that costs incurred were recovered within the relevant formula period.

7 Final Proposal

7.1 National Grid has not identified any changes to the terms of the original proposal as a result of representations received.

7.2 National Grid proposes that:

Trigger

- The TO Entry Commodity rebate mechanism would be triggered if there remained a residual over recovery amount after taking into account any revenue redistributed by the buy-back offset mechanism
- The process would be triggered at the end of the formula year based on the outcome of all NTS Entry Capacity auctions that represent a TO revenue stream.

Mechanism

- As specified by GCM09, any residual over recovery at the end of the formula year would first 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
- Any residual over recovery revenue, taking into account any payments resulting from the buy-back offset process, would be available as a rebate to shippers
- Credits would only be paid if the residual over recovery was in excess of £1M (this equates to the minimum TO Entry Commodity price of 0.0001 p/kWh)
- The ratio of the remaining TO over recovery amount and the TO Entry Commodity Revenue paid (April 07 to September 07 for the 2007/8 formula year) would be calculated
- The ratio would be capped at 1 i.e. only rebate TO Entry Commodity revenue received
- Rebate of TO Entry Commodity charges paid earlier in the formula year based on the ratio
- Rebate paid via April invoice following formula year i.e. April 2008 invoice for the current formula year

<u>Implementation</u>

It is proposed that these arrangements are implemented from 1st March 2008 to compliment the existing TO over-recovery buy-back offset mechanism.

8 How the Proposed Modification Achieves the Relevant Objectives

Assessment against Licence Objectives

8.1 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.

8.2 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.

8.3 National Grid believes that GCM10 would satisfy the relevant objectives as, in improving the efficiency of the TO Entry Commodity process, the likelihood of over recovery is reduced and hence the aggregate charges would more closely reflect the costs incurred within the formula year.

8.4 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".

8.5 Responses to the GCM10 consultation have highlighted the importance that costs and revenues are targeted and allocated as accurately as possible within the formula year as, in broad terms, this would normally be argued to be beneficial for competition in that it creates a level playing field. GCM10 would limit the redistribution of excess auction revenues to the relevant parties, i.e. those who have participated in the entry capacity auctions; and, as such GCM10 should help promote competition between shippers.

Assessment against EU Gas Regulations

8.6 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.

8.7 National Grid believes that GCM10 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 – History of TO Over/Under Recovery NTS Charging Methodology Proposals

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**
GCM09	TO Over Recovery Mechanism	Revise the buy-back offset mechanism to; ○ make the full over recovery amount available in the first month ○ make retrospective credits in relation to any buy-back costs incurred earlier within the formula year, ○ make credits up to the buy-back cost rather than up to the net buy-back cost, ○ clarify that the mechanism can be triggered by any NTS Entry Capacity auction that represents a TO revenue	**Not vetoed**

Appendix B – Example

Residual revenue after the "buy-back Offset" mechanism	£12.35m
TO Entry Commodity Collected	£46.80m[3]
Rebate ratio	26.39%

	UDQI (TWh) [Excluding storage & short-haul]	TO Entry Commodity Rate (p/kWh)	TO Entry Revenue	Rebate
April	40	0.0120	£4.80m	£1.27m
May	50	0.0120	£6.00m	£1.58m
June	60	0.0120	£7.20m	£1.90m
July	70	0.0120	£8.40m	£2.22m
Aug	80	0.0120	£9.60m	£2.53m
Sept	90	0.0120	£10.80m	£2.85m
Oct	100	0	£0.00	£0.00
Nov	110	0	£0.00	£0.00
Dec	120	0	£0.00	£0.00
Jan	130	0	£0.00	£0.00
Feb	120	0	£0.00	£0.00
Mar	110	0	£0.00	£0.00
Total	1080	0	£46.80m	£12.35m

Each Shipper will receive a proportion of the rebate based on its proportion of the relevant UDQI in each month. This is equivalent to each shipper receiving a rebate equal to the calculated ratio multiplied by its TO Entry Commodity charges.

[3] This example is indicative only. The UDQIs, and therefore the collected revenue, have been generated solely for the purposes of this example