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CONCLUSIONS REPORT TO THE AUTHORITY

Modification Proposals to the Gas Transmission Transportation Charging Methodology

NTS GCM 11:

‘Retrospective Negative TO Entry Commodity Charge’

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 credit mechanism representing a ‘Retrospective Negative TO Entry Commodity Charge’. This mechanism would be used to manage TO entry revenue over recovery in the event that there was a residual over recovery amount after any credits from the buy-back offset mechanism and the TO Entry Commodity rebate mechanism (as proposed through GCM10). This document is issued by National Grid in its’ role as Gas Transporter Licence holder in respect of the NTS (“National Grid”).

From 1st October 2007 the TO Entry Commodity charge rate has been set at zero. Revenue from the remaining RMSEC auctions and the £13.4m implied revenue resulting from the Entry Capacity Trade & Transfer processes, introduced through UNC Modification Proposals 0169, will result in TO Entry 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.

As a consequence, National Grid raised Charging Proposal NTS GCM 10, which proposed the introduction of a TO Entry Commodity charge rebate mechanism. The TO Entry Commodity charge had been set at 0.0120 p/kWh from 1st April 2007 to 30th September 2007 and collected approximately £46.7m. GCM10 would therefore allow for up to £46.7m of 2007/8 over recovery to be redistributed.

This proposal, GCM11, would introduce a credit mechanism representing a retrospective negative TO Entry Commodity charge which would allow over recovery, in excess of that managed through the buy-back offset and GCM10 (if implemented) processes, to be re-distributed. This should allow for any potential TO Entry revenue over recovery amount to be managed.

If NTS GCM 10 were implemented, there remains a risk that the mechanism would not fully redistribute the residual over recovery amount. 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 GCM10 mechanism being ineffective is highly unlikely to be the case for the 2007/8 formula year.

The risk of the GCM10 mechanism being vetoed or not being fully effective in future formula years remains and hence this proposal has been raised at this time as a logical progression of the GCM10 approach.

GCM11: National Grid proposes through this document that:

Trigger

- The credit mechanism, representing a Retrospective Negative TO Entry Commodity charge, would be used if there remained a residual over recovery amount after taking into account any revenue redistributed via the Entry Capacity buy-back offset TO over recovery mechanism (as revised through GCM09) and the TO Entry Commodity Rebate Mechanism (as described in GCM10 and subject to implementation)
    - The TO Entry Commodity rebate (GCM10) mechanism, subject to Ofgem non-veto, 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 (GCM09) had not been triggered
- The mechanism would be triggered at the end of the formula year based on the outcome of all NTS Entry Capacity auctions that represented a TO revenue stream.

Mechanism

- Any residual revenue remaining after taking into account credits resulting from the Entry Capacity buy-back offset (GCM09) and the TO Entry Commodity Rebate (GCM10) mechanisms (if implemented) would be available as a credit to shippers.
- Credits would only be paid based on relevant entry allocations i.e. those allocations that would attract the TO Entry Commodity charge.
- Each Shipper's credit would be calculated as a proportion of the total available credits from the ratio of Shipper relevant entry allocations to total relevant entry allocations over the formula year.
- 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)
- Credits would be capped at the level of the SO Entry Commodity charge level such that the combined impact of SO and TO Entry Commodity charges and any credits paid through this proposed mechanism, did not represent a net credit to Shippers.
- Credits would be paid following the end of the formula year based on relevant entry allocations i.e. those allocations that would attract the TO Entry Commodity charge

<u>Implementation</u>

It is proposed that these arrangements are implemented with effect for the current formula year and hence from 31st March 2008.

<u>Future Proposals</u>

This proposal represents the final step in addressing TO over recovery following on from GCM09 and GCM10. National Grid anticipate that further TO Entry over recovery proposals might only be required should GCM10 or GCM11 be vetoed or in response to further changes to the UNC.

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. The £13.4m revenue implied by 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.

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.

3.3 TO Entry Capacity charges are based on pay-as-bid auctions and any forecast under recovery is managed by setting the TO Entry commodity charge.

3.4 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 has 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 entry baseline capacity changes and the anticipated trade and transfer processes. The rate applied from 1st April 2007 represents the first time that a non-zero rate has been applied for the first six months of a formula year. This was in response to industry concerns about price stability; previously a non-zero rate had only been applied in the October to March period.

3.5 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 prevailing 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.

4.3 As a consequence, National Grid raised charging proposal NTS GCM 10 which seeks to address this issue by introducing a TO Entry Commodity charge rebate to manage any residual over recovery remaining after taking into account any credits paid via the TO over recovery buy-back offset mechanism.

4.4 Even if NTS GCM 10 were implemented, there remains a risk that the mechanism would not fully redistribute the residual over recovery amount. 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 GCM10 mechanism being ineffective is highly unlikely to be the case for the 2007/8 formula year.

4.5 The risk of the GCM10 mechanism not being fully effective in future formula years remains and this could be over come by allowing the TO Entry Commodity charge to be negative.

TO Entry Commodity Charge Issues

4.6 Proposals have been raised in the past to introduce a negative TO Entry 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 mechanism charging proposals is outlined in appendix A.

4.7 The difficulty with a negative TO entry commodity charge in combination with the TO entry 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.

4.8 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 commodity rate to be set within the formula year given the charge notice requirements within the Licence and the UNC. These issues could be addressed by applying the charge retrospectively.

‘Retrospective Negative TO Entry Commodity Charge’

4.9 Retrospective credits representing a negative TO Entry Commodity charge having applied, rather than actually applying a negative commodity charge rate, would allow over recovery to be managed without needing to forecast entry revenue or buy-back costs.

4.10 Concerns have been expressed that a negative commodity charge may affect Shipper incentives to flow gas. Shippers are however exposed to the net SO and TO Entry Commodity charge and hence there would be no change in the incentive properties of the net NTS Commodity charge (SO plus TO) if the TO component were to be negative unless this resulted in the net commodity charge being negative.

4.11 Shippers can already calculate the approximate impact on their net entry commodity charge of the cost of any entry capacity they purchase and this would not change should the TO component be negative. Every £1m spent on entry capacity will result in a 0.0001 p/kWh reduction in the TO Entry Commodity charge over a 12 month period. There should therefore be no change in capacity bidding behaviour as a result of this proposal.

Mechanism Trigger

4.12 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.

4.13 The GCM09 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 credit, representing negative TO Entry Commodity charge having applied.

4.14 The process could operate 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 and the proposed TO Entry Commodity Rebate mechanism (GCM10).

Mechanism

4.15 This proposal would represent retrospectively setting the TO Entry Commodity rate to a negative value. Credits might therefore only be paid if the residual over recovery was in excess of £1m as this equates to the minimum negative TO Entry Commodity price of -0.0001 p/kWh. This same approach has been proposed in relation to the TO Entry Commodity rebate proposal NTS GCM 10.

4.16 Credits would also be capped at the level of the SO Entry Commodity charge level such that the combined impact of SO and TO Entry Commodity charges and credits did not represent a net credit to Shippers.

4.17 An example of how the mechanism would be operated and how the prevailing TO Entry over recovery (GCM09) and the proposed TO Entry Commodity rebate (GCM10) and ‘Retrospective Negative TO Entry Commodity’ (GCM11) mechanisms would interact given a range of over recovery and buy-back levels is included in Appendix B.

5 Terms of the Original Proposal

5.1 National Grid proposed that:

Trigger

- The Retrospective Negative TO Entry Commodity charge would be used if there remained a residual over recovery amount after taking into account any revenue redistributed via the TO Entry Commodity Rebate Mechanism (as described in GCM10 and subject to implementation)
    - The TO Entry Commodity rebate (GCM10) 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 (GCM09) or the TO Entry Commodity Rebate Mechanism (GCM10) had not been triggered
- The mechanism would be triggered at the end of the formula year based on the outcome of all NTS Entry Capacity auctions that represented a TO revenue stream.

Mechanism

- Any residual TO entry revenue remaining after taking into account credits resulting from the Entry Capacity buy-back offset (GCM09) and the TO Entry Commodity Rebate (GCM10 subject to implementation) mechanisms would be available as a credit to shippers .
    - As specified by GCM09, any residual over recovery at the end of the formula year would first be used to offset buy-backs 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.
    - As specified by GCM10 and subject to a decision by Ofgem, any residual over recovery at the end of the formula year would secondly be used to rebate TO Entry Commodity charges paid within the formula period.
- Credits would only be paid based on relevant entry allocations i.e. those allocations that would attract the TO Entry Commodity charge.
- Each Shipper's credit would be calculated as a proportion of the total available credits from the ratio of Shipper relevant entry allocations to total relevant entry allocations over the formula year.
- 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)
- Credits would be capped at the level of the SO Entry Commodity charge level such that the combined impact of SO and TO Entry Commodity charges and credits did not represent a net credit to Shippers.
- Credits would be paid following the end of the formula year based on relevant entry allocations i.e. those allocations that would attract the TO Entry Commodity charge

Implementation

It was proposed that these arrangements are implemented with effect for the current formula year and hence from 31st March 2008. Implementation of this proposal is not dependent on GCM10.

6 Representations Made

National Grid NTS received 10 responses to its consultation on NTS GCM 11; 8 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.[1]

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
Conoco Phillips	CON	Support
British Gas Trading	BGT	Not in support
EDF Energy plc.	EDF	Not in support

Summary of Responses by Consultation Question

Q1. The Retrospective Negative 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."

[1] GCM11 consultation responses can be found at ;

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

RWE “support the proposals put forward in GCM11 and believe that they represent an improvement over the existing arrangements. Introduction of a mechanism to manage residual TO entry revenue over recovery will complement the buy-back offset mechanism and the proposed TO entry commodity rebate mechanism (GCM10).”

SGD supports GCM11 as it “considers it important that costs and revenues are targeted and allocated as accurately as possible. In the case of entry capacity, any excess revenue should be redistributed amongst entry capacity holders alone; given that there are circumstances in which GCM 10 may not be entirely effective, ie. when any over recovery is in excess of revenue that can be collected through the TO Commodity Charge, GCM 11 offers a means of ensuring that redistribution remains targeted amongst entry capacity holders”

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 should as far as possible be ‘ring-fenced’ to NTS Entry charges, without influencing future capacity bidding behaviour.

Q3. Any residual TO entry revenue remaining after taking into account credits resulting from the Entry Capacity buy-back offset (GCM09) and the TO Entry Commodity Rebate (GCM10) mechanisms would be available as a credit to shippers .

Respondents’ Views

RWW “consider that the application of GCM11 should be as described by the mechanism set out in the consultation paper, as this will ensure that costs and revenues are accurately targeted and allocated.”

EXM “supports GCM11, because we believe that it will allow National Grid to appropriately redistribute any over recovered revenue which is in excess of the amount recovered by the TO Commodity Charge and will remedy any events that are not covered by GCM09 and GCM10.”

CON comments “The proposal to trigger the retrospective TO entry commodity charge after the processes described in NTS GCM 09 and NTS GCM 10, if implemented, is appropriate. The proposal to trigger the mechanism at the end of the formula year is appropriate”

CON comments “Although we support the proposal we consider that a holistic consideration of how to approach a potential over recovery would have been preferable to the current incremental and piecemeal approach represented by NTS GCM 9-11. “ CON “note that in the consultation for NTS GSM 10 National Grid raised the idea of having a final payment to manage either over or under recovery and, since it acknowledges that it is highly unlikely that NTS GCM 10 would be ineffective at dealing with the over recovery this year, it seems there would have been time to develop and propose a more complete solution at that stage.”

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 to seek to further improve the NTS Charging Methodology.

While National Grid appreciates concerns regarding piecemeal change to the regime, proposals GCM9, GCM10 and GCM11 were developed in parallel and discussed together at the Gas TCMF meetings[2]. These proposals were only raised separately as GCM09 represented a 'tidy-up' proposal while GCM10 and GCM11 represented two more significant and arguably distinct steps in the over recovery process. National Grid is mindful that the authority only has the right of veto over a complete proposal and cannot make decisions on individual aspects.

Q4. 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).

Q5. Credits would be capped at the level of the SO Entry Commodity charge level such that the combined impact of SO and TO Entry Commodity charges did not represent a credit to Shippers.

Respondents' Views

RWE "agree that there should be a de minimis of £1m and that, when combined with the SO Commodity charge, the net charge should not to lead to a credit for Shippers. Applying the charge retrospectively will also avoid the additional complication of forecasting the level of any charge against the background of uncertain ex ante auction revenues."

CON comments "The proposal that any residual TO entry revenue after taking account of credits from NTS GCM 09 and NTS GCM 10 would be available as a credit to shippers is appropriate. We support the proposal that each shipper's credit would be calculated in proportion to their share of entry allocations that would attract the TO entry commodity charge over the formula year. The de minimus level of £1mn seems in order given transactional costs, as is the timing of payments at the end of the formula year. We also support that credits should be capped at the level of the SO entry commodity charge so that TO and SO charges together do not represent a credit to shippers"

SGD comments; "With regards to over-recoveries under £1m, SGD assumes that these would feed through into the K mechanism? The document is silent on this point. As for the figure itself, while SGD understands the rationale behind its calculation, ie. the link with the lowest possible TO Commodity Charge, £1m does seem a rather excessive threshold. Although it is not clear (at least at this stage) on what basis an alternative threshold could be established, it would be appreciated if National Grid could give this matter further thought."

[2] References to the development of GCM09, GCM10 and GCM11 can be found on the Gas TCMF section of National Grid's website at http://www.nationalgrid.com/uk/Gas/Charges/TCMF/ under the July, September, November and December 2007 meetings.

National Grid's View

National Grid continues to believe 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.

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. Any over recovery would still feed into the K mechanism.

National Grid believes that, while this proposal represents a 'negative TO commodity charge' having applied, the restriction on the net (TO plus SO) commodity rate not being negative will avoid any perverse incentives.

Q6. Credits would be paid following the end of the formula year based on relevant entry allocations i.e. those allocations that would attract the TO Entry Commodity charge

Respondents' Views

BG "supports GCM 11 on the basis that it enables refund of TO Over recovery in the event that GCM 09 or GCM 10 prove insufficient. It is reasonable that over recovery due to entry charges should be returned to those shippers who pay entry charges rather than shared via the k mechanism with shippers who pay exit charges. It is also sensible that GCM 11 should only be triggered at the end of the formula year when the exact size of any over recovery is known. This will avoid any unnecessary instability in charges."

STUK "considers that GCM 11 should ensure the correct apportion of credits, through basing them on relevant entry allocations."

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

BGT comments that GCM11 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 GCM11 proposed mechanism.

Respondents' Views - Notice

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 "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."

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."

National Grid's View

GCM11 proposes a rebate, i.e. a credit to Shippers, and therefore does not represent a charge being levied i.e. requiring shippers to pay. 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.

Q7. These arrangements are implemented with effect for the current formula year and hence from 31st March 2008.

Respondents' Views

RWE comments "Given that an understanding of any over recovery mechanisms is an important component in shippers understanding the entry capacity regime overall, we would urge Ofgem to take a timely decision on this and other outstanding pricing consultations."

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 and 11 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.

Summary of Responses by Relevant Objectives

SSE supports and agrees that the proposed changes "meet National Grid Gas's relevant GT Licence objectives" and "believes the proposal contained in GCM11 satisfies the relevant methodology objectives"

Reflect the Cost Incurred by the Licensee

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 re-distributed within the same formula year."

CON Comments "Under the existing rules, and even if NTS GCM 10 is implemented, any over recovery beyond that will be distributed through the "K" factor equally to entry and exit users and therefore it would not be accurately targeted at those who contributed to the surplus. The proposal targets the surplus at entry users and relates to the year in which the surplus was generated, and in this respect it better meets the licence objectives as aggregate charges would more closely reflect the costs incurred within the 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. We therefore support the objective of this proposal"

SGD comments "GCM 11 will help achieve the relevant methodology objectives contained in Standard Special Condition A5 of National Grid's GT licence. In particular" … "the subsequent accuracy and appropriateness of the TO Entry Commodity Charge should better reflect the costs incurred by National Grid"

Take Account of Developments in the Transportation Business

EON “believe this proposal (in conjunction with GCM 09 & 10) offers a pragmatic solution to the over recovery difficulties caused by the unpredictable nature of auctions for entry capacity. This situation can be contrasted with TO Exit Capacity charges, which are administered to collect all TO revenue without the need for numerous and complex adjustment mechanisms.”

BG “remains concerned about the potential interactions between the nature of the entry capacity regime and the charging regime. I would therefore urge NG and Ofgem to take such interactions into account when making changes to either regime because of their potential impact on shippers’ behaviour.”

STUK “considers that the proposed mechanism should mitigate the risk that any residual over recovery amount would not be fully redistributed, should GCM 10 be vetoed or is not fully effective in future formula years. This risk is of particular concern, given the increased likelihood of over recovery, through the Trade and Transfer process.”

SGD comments “GCM 11 will help achieve the relevant methodology objectives contained in Standard Special Condition A5 of National Grid’s GT licence. In particular” … “GCM 11 clearly takes into account potential developments in the entry capacity auction regime that might result in excess revenues, the redistribution of which would not be targeted at entry capacity holders.”

Facilitate Effective Competition

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.”

SGD comments “GCM 11 will help achieve the relevant methodology objectives contained in Standard Special Condition A5 of National Grid’s GT licence. In particular” … “preventing any erroneous flow of monies between entry and exit could be expected to further competition between gas shippers and gas suppliers”.

Entry v Exit Arrangements

EDF "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 " is aware that as a result of the change in baselines, and a significant change in bidding behaviour and prices NGG is exposed to a TO over recovery, currently standing at £13.4m to the year to date. This is in contrast to NGG's licence objectives to use best endeavours not to over recover revenue and will expose them to a penal interest rate under the TPCR. Further this over recover is in contrast to NGG's objective of recovering 50% of TO revenue from entry and 50% from exit capacity charges. We therefore 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 GCM11 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 "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 is 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 GCM11, 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."

National Grid's View

National Grid continues to believe that the GCM11 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. GCM11 is attempting to address this discrepancy.

Risk	Mitigation	Risk mitigated?
TO Exit Under-recovery	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.	✓
TO Exit Over recovery		✓
TO Entry Under-recovery	Entry auction reserve prices and the TO Entry Commodity charge limit the potential for significant under recovery	✓
TO Entry Over recovery	The buy-back offset mechanism, introduced via PC65 and modified via GCM09, provides some protection against TO entry over recovery as would the proposed (GCM10) TO entry commodity rebate mechanism (subject to implementation). **These mechanisms will not be fully effective if the implied over recovery revenue is in excess of buy-back costs and TO entry commodity revenue collected.**	✗

National Grid does not see this objection, i.e. that similar arrangements should exist for entry and exit over and under recovery, as a reason not to progress the GCM11 proposals as they are seeking to reduce the disparity between the likelihood of over recovery of entry, and exit revenue.

In regard to the comments suggesting separate management of the Licence defined over and under recovery mechanism (the 'K' mechanism) separately for entry and exit, 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 proposes that:

Trigger

- The 'Retrospective Negative TO Entry Commodity' mechanism would be used if there remained a residual over recovery amount after taking into account any revenue redistributed via the buy-back offset mechanism (as described in GCM09) and the TO Entry Commodity Rebate Mechanism (as described in GCM10, subject to implementation)
- The mechanism would be triggered even if the buy-back offset mechanism (GCM09) had not been triggered
- The mechanism would be triggered at the end of the formula year based on the outcome of all NTS Entry Capacity auctions that represented a TO revenue stream.

Mechanism

- Any residual TO entry revenue remaining after taking into account credits resulting from the Entry Capacity buy-back offset (GCM09) and the TO Entry Commodity Rebate (GCM10 subject to implementation) mechanisms would be available as a credit to shippers .
    - As specified by GCM09, any residual over recovery at the end of the formula year would first be used to offset buy-backs 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.
    - As specified by GCM10 and subject to a decision by Ofgem, any residual over recovery at the end of the formula year would secondly be used to rebate TO Entry Commodity charges paid within the formula period.
- Credits would only be paid based on relevant entry allocations i.e. those allocations that would attract the TO Entry Commodity charge.
- Each Shipper's credit would be calculated as a proportion of the total available credits from the ratio of Shipper relevant entry allocations to total relevant entry allocations over the formula year.
- 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)
- Credits would be capped at the level of the SO Entry Commodity charge level such that the combined impact of SO and TO Entry Commodity charges did not represent a credit to Shippers.
- Credits would be paid following the end of the formula year based on relevant entry allocations i.e. those allocations that would attract the TO Entry Commodity charge

Implementation

It is proposed that these arrangements are implemented with effect for the current formula year and hence from 31st March 2008. Implementation of this proposal is not dependent on GCM10.

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 GCM11 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 GCM11 should prevent cross subsidies between entry and exit Users and hence should facilitate effective competition between gas shippers and between gas suppliers.

8.5 Previous proposals to introduce a negative TO Entry commodity charge as a means of managing TO entry revenue over recovery have been vetoed on the grounds that it was unclear how a rate would be set in light of the entry capacity buy-back offset mechanism. National Grid believes that GCM11 overcomes these concerns by proposing a retrospective mechanism that would operate after any payments had been made via the buy-back offset mechanism and hence there should be greater transparency as to how the mechanism would be operated and the revenue that would be redistributed.

8.6 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”.

Assessment against EU Gas Regulations

8.7 EC Regulation 1775/2005 on conditions for access to the natural gas transmission networks (binding from 1 July 2006) are summarised below. 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.

8.8 National Grid believes that GCM11 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.

8.9 Previous proposals to introduce a negative TO Entry commodity charge as a means of managing TO entry revenue over recovery have been vetoed on the grounds that it was unclear how a rate would be set in light of the entry capacity buy-back offset mechanism. National Grid believes that GCM11 overcomes these concerns by proposing a retrospective mechanism that would operate after any payments had been made via the buy-back offset mechanism and hence there should be greater transparency as to how the mechanism would be operated and the revenue that would be redistributed.

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**
GCM10	TO Entry Commodity Rebate	Revise the TO entry over recovery mechanism by; ○ introducing a TO Entry Commodity Charge rebate mechanism in relation to TO Entry Commodity charges paid earlier in the year	**Consultation Closed – Report in preparation**

Appendix B – Examples

The following table outlines how the prevailing TO Entry over recovery (GCM09) and the proposed TO Entry Commodity rebate (GCM10) and 'Retrospective Negative TO Entry Commodity' (GCM11) mechanisms would interact given a range of over recovery and buy-back levels.

Mechanism	Step	Example 1	Example 2	Example 3
Buy-back Offset (GCM09)	Over recovery	£15m	£15m	£55m
	Buy-back Costs	£20m	£5m	£5m
	Credit	£15m	£5m	£5m
	Residual	£0m	£10m	£50m
TO Entry Commodity Rebate (GCM10)	TO Entry Commodity collected	£40m	£40m	£40m
	Ratio	0%	25%	100%
	Rebate	£0	£10m	£40m
	Residual	£0	£0	£10m
'Retrospective Negative TO Commodity' (GCM11)	Credit	£0	£0	£10m

The following table shows how the GCM11 credit would be redistributed. Each Shipper will receive a proportion of the rebate based on its proportion of the relevant UDQI in each month.

	UDQI (TWh) [excluding storage & short-haul]	**Rebate**
April	40	£0.37m
May	50	£0.46m
June	60	£0.56m
July	70	£0.65m
Aug	80	£0.74m
Sept	90	£0.83m
Oct	100	£0.93m
Nov	110	£1.02m
Dec	120	£1.11m
Jan	130	£1.20m
Feb	120	£1.11m
Mar	110	£1.02m
Total	1080	**£10.00m**