ofgem

Promoting choice and value for all gas and electricity customers

Modification proposal:	**Modification Proposal NTS GCM 11 'Retrospective Negative TO Entry Commodity Charge'**		
Decision:	**The Authority[1] has decided to veto this proposal[2]**		
Target audience:	**NGG and other interested parties**		
Date of publication:	**8 February 2008**	Implementation Date:	**N/A**

Background to the modification proposal

National Grid Gas (NGG) recovers its Transportation Owner (TO) allowed revenue (other than revenue collected through the Distribution Network pensions charge) through exit and entry charges based on a 50/50 split. Entry capacity charges are recovered from sales of entry capacity through a series of capacity auctions. However, if the revenue through these auctions is projected to fall short of 50% of TO allowed revenue, the shortfall is recovered through TO Entry Commodity Charges, which are estimated and levied by NGG. If revenue recovery is in excess of 50% of TO allowed revenue there is mechanism to offset the over-recovery against any entry capacity buy-back costs that NGG incurs. However, in the event that NGG's entry capacity buy-back costs are less than any over-recovery amount, the mechanism will not fully redistribute the over-recovery amount. In these circumstances, the remaining surplus is carried forward to the following year and offset against the total allowed revenue in that year leading to lower entry and exit charges for users.

NGG has proposed GCM 10 (TO Entry Commodity Rebate Mechanism) as a means of redistributing to shippers at entry any residual over-recovery at the end of a formula year following the application of the buy-back offsetting mechanism by rebating the TO Commodity Charge. The Authority has decided not to veto that proposal and a separate decision letter explains the reasons for that decision. GCM 11 has been proposed to deal with any remaining over-recovery if the TO Commodity Charge has been fully rebated through the implementation of GCM 10.

The modification proposal ("the Proposal")

Under modification proposal NTS GCM 11 (Retrospective Negative TO Entry Commodity Charge), NGG propose to introduce an end of year credit mechanism representing a retrospective negative TO Entry Commodity charge. This would allow any residual revenue over-recovery, in excess of that managed through the buy-back offset and GCM10 processes, to be re-distributed. This should allow for any potential TO Entry revenue over-recovery amount to be managed within the existing charging and formula year.

The main characteristics of the proposed mechanism are:

- 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 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.

[1] The terms 'the Authority', 'Ofgem' and 'we' are used interchangeably in this document. Ofgem is the Office of the Gas and Electricity Markets Authority.
[2] This document also constitutes notice of the reasons for this decision as required by section 38A of the Gas Act 1986.

- Each Shipper's credit would be calculated as a proportion of the total available credits from the ratio of Shipper relevant entry flows to total relevant entry flows 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[3] 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

NGG proposes implementation from 31 March 2008.

Justification of the modification proposal

NGG considers that NTS GCM 11 better achieves the relevant gas transmission transportation charging methodology objectives in that:

- reducing the likelihood of over-recovery results in charges which reflect costs incurred by the licensee in its transportation business
- the projected over-recovery of revenues is partly as a result of changes in the Entry capacity regime, so acting to mitigate the effect takes account of developments in the transportation business
- the targeted redistribution of over-recovered revenues to those parties who contributed to the revenues should facilitate effective competition between gas shippers and between gas suppliers

Responses to NTS GCM 11

NGG consulted on the proposals in November 2007 and received ten responses. Eight respondents supported implementation of GCM 11 and two did not support its implementation.

There was general support for both the principle of rebating any residual over-recovery (after the application of the buy-back offsetting mechanism and GCM 10) to those Entry shippers who had contributed to the over-recovery. They considered that such a targeted rebate avoided cross-subsidy of Exit (as would happen if the residual was offset against the following year's allowed revenue) and so would facilitate competition between shippers. Some respondents queried as to whether the *de minimis* threshold could be set at a lower level than the proposed £1m.

Those who opposed the modification considered that it would be discriminatory to Exit users as they do not benefit from the rebate of over-recovery on Entry but are still exposed to under-recovery of charges at Entry. Additionally, one respondent considered that it discriminated against users whose gas enters the system but uses the NTS

[3] The SO Entry Commodity Charge is a charge per unit of gas transported by the NTS. It is applied uniformly on both entry and exit on all NTS system points. However, it is not currently fully applied to gas flows on NTS storage facilities. This charge is levied to recover the NTS System Operator allowed revenue.

Optional Commodity Charge[4] rather than the TO Commodity Charge. The same respondent commented that NGG should be paying interest on the excess revenues and that the modification should be taking account of this. Finally, a respondent was concerned that if GCM 11 was to be approved, it would set a precedent for an under-recovery charge to be introduced and such a charge would have a destabilising effect on shipper charges.

One respondent considered that a holistic approach to the issue of over-recovery would have been preferable to the piecemeal approach taken through modification proposals GCM 09, GCM 10 and GCM 11. Furthermore, as the mechanism in GCM 11 may not be required for 2007/8 then more time could have been given to developing an enduring regime.

The Authority's decision

The Authority has considered the issues raised by the modification proposal and the Conclusions Report dated 11 January 2008. The Authority has considered and taken into account the responses[5] to NGG's consultation. The Authority has concluded that:

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

Reasons for the Authority's decision

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

If implemented, GCM 11 would apply in the situation where auction revenues alone have exceeded the sum of target allowed revenue and any buy-back costs[8]. Ofgem agrees with the respondents that this would lead to a recovery in excess of projected costs for that year. We note respondents' views that GCM 11 has the potential to improve cost reflectivity as aggregate charges after any such rebate would more closely reflect the costs incurred within the formula year. However, cost reflectivity is not the primary concern in the context of capacity auctions that reveal the market value of potentially constrained transmission entry capacity. The charging methodology (and relevant licence conditions) for gas makes it clear that charges determined through capacity auctions may reflect market value rather than costs.

---

[4] The NTS Optional (commonly referred to as short-haul) Commodity Charge reflects the costs of gas transportation from a terminal to a nearby large supply point. Shippers can elect to pay the optional tariff as an alternative to both the entry / exit NTS SO Commodity Charge and the NTS TO Commodity Charge.
[5] NGG modification proposals, modification reports and representations can be viewed on the NGG website at www.nationalgrid.com
[6] As set out in Standard Special Condition A5(5) of NGG's Gas Transportation Licence, see: http://epr.ofgem.gov.uk/document_fetch.php?documentid=8783
[7] The Authority's statutory duties are wider than matters which the Panel must take into consideration and are detailed mainly in the Gas Act 1986.
[8] This amount would also need to be greater than the *de minimis* threshold of £1m

Therefore we do not see GCM 11 as leading to more cost reflective charges nor do we believe this is relevant, as any over-recovery is signalling that the market value of entry is in excess of the costs of providing that capacity.

Compliance with the charging methodology facilitates effective competition between gas shippers and between gas suppliers - SSC A5(5)(c)

Respondents in support of GCM 11 said that it would prevent cross subsidies between Entry and Exit Users and should facilitate effective competition between gas shippers and between gas suppliers. A major concern expressed by a respondent against the proposal was that it is discriminatory to Exit users, as they do not benefit from Entry over-recovery but remain exposed to Entry under-recovery.

Ofgem does not think that the existing arrangements discriminate unduly against Exit users. The charging methodology aims to collect allowed revenue equally from entry and exit charges. Ofgem accepts that if either auction revenues are below expectations or NGG incorrectly forecasts the TO Commodity Charge levels, then there will be an under-recovery which would be carried through to the following year's charges. Exit users will then be exposed to 50% of what should be a relatively small under-recovery amount. However, this risk is symmetric as if there is a significant over-recovery then they benefit in the same way in subsequent years. Ofgem considers that this is reasonable and will not distort competition, whereas the implementation of GCM 11 would remove this symmetry and be discriminatory to exit users.

Decision notice

In accordance with Standard Special Condition A5 of NGG's Gas Transportation Licence, the Authority has decided to veto modification proposal GCM 11: Retrospective Negative TO Entry Commodity Charge.

Robert Hull
Director, Transmission

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