nationalgrid

CONCLUSIONS REPORT TO THE AUTHORITY

Modification Proposals to the Gas Transmission Transportation Charging Methodology

NTS GCM 18R:

NTS Entry Capacity Retention Charges

19th November 2009

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Executive Summary

This document is issued by National Grid Gas plc ("National Grid") in its role as holder of the Gas Transporter Licence in respect of the NTS (the "Licence").

This document sets out a final proposal for amending the Gas Transmission Transportation Charging Methodology (the "Charging Methodology") in respect of the introduction of an NTS Entry Capacity Retention Charge.

This proposal, GCM18, would also ensure that revenue recovered from Users in regard to the proposed NTS Entry Capacity Retention Charges would appropriately offset other NTS transportation charges.

As a result of the consultation process there is one change to the proposed methodology. The charge rate has been increased from 0.2920p/kWh to 0.2922p/kWh to reflect leap years.

National Grid proposes through this document that:

- NTS Entry Capacity Retention Charges in regard to non-incremental obligated entry capacity would be calculated based on the minimal capacity charge rate of 0.0001 pence per kWh per day applying over a time period of 32 quarters; this equates to 0.2922 p/kWh of entry capacity retained.
- NTS Entry Capacity Retention Charges and refunds in regard to non-incremental obligated entry capacity would be treated as TO revenue;
    - this would result in reduced TO Entry Commodity Charges in the case of charges incurred for retained capacity or increased TO Entry Commodity Charges in the case of subsequent refunds.

<u>Implementation</u>

It is proposed that these arrangements are implemented with effect from 1 January 2010 to be consistent with the approval by the Authority, if given, of the Entry Capacity Substitution Methodology Statement (the "substitution methodology statement") and UNC Modification Proposal 265 "Creation of an NTS Entry Capacity Retention charge within the Uniform Network Code". These arrangements would therefore be applicable to the retention of entry capacity that could otherwise be substituted in auctions on or after 1 March 2010.

1 Introduction

1.1 This document is issued by National Grid Gas plc ("National Grid") in its role as holder of the Gas Transporter Licence in respect of the NTS (the "Licence").

1.2 This document sets out a final proposal for amending the Gas Transmission Transportation Charging Methodology (the "Charging Methodology") in respect of the introduction of an NTS Entry Capacity Retention Charge.

1.3 This proposal, GCM18, would ensure that revenue recovered from Users in regard to NTS Entry Capacity Retention Charges would appropriately offset other NTS transportation charges.

2 Background

2.1 The 2007 Transmission Price Control Review created a new obligation on National Grid to undertake Entry Capacity Substitution (see Licence condition C8D paragraph 10 and C8A paragraph 1). This obligation requires National Grid to use reasonable endeavours to undertake entry capacity substitution when proposing to release capacity incremental to the prevailing level of obligated entry capacity, thus seeking to minimise the amount of investment that is required to satisfy incremental demand.

2.2 Substitution is where National Grid moves unsold non-incremental obligated entry capacity from one ASEP to meet the demand for incremental obligated entry capacity at a different ASEP.

2.3 In accordance with the Licence, National Grid is required to implement Entry Capacity Substitution from, and including, the March 2010 QSEC auction and was required to submit its proposed Methodology Statement to the Authority for approval no later than 7th September 2009.

2.4 After a series of industry workshops throughout 2008 and 2009, and an informal consultation in May 2009, a proposed substitution methodology statement was submitted to the industry for formal consultation* on the 24th July 2009. This proposed methodology is based on the "Options Approach" developed through the workshops. To avoid confusion with other Option products, references to "Options" have been replaced with "Retainer" as this more accurately describes the role of the product.

2.5 Assuming the substitution methodology statement is approved and substitution is implemented in accordance with the proposed methodology, Users will be able to exclude unsold non-incremental obligated entry capacity at potential donor ASEPs from being substituted away, in response to an incremental signal elsewhere, by the purchase of a Retainer. The rules and processes for Retainers are detailed in the proposed substitution methodology statement which includes the requirement for a charge to be paid in respect of a Retainer.

* This can be found on National Grid's website at http://www.nationalgrid.com/uk/Gas/Charges/statements/transportation/ecms/

2.6 Concurrent to this charging proposal and the substitution methodology statement consultation, National Grid has raised an associated UNC Modification Proposal. The UNC Modification Proposal[1] is required to define the NTS Entry Capacity Retention Charge as a Transportation Charge within the UNC and so allow National Grid the ability to invoice for the revenue associated to this charge; hence, approval of this proposal is integral to the implementation of entry capacity substitution.

3 Discussion and Issues

Introduction

3.1 A Modification to the Charging Methodology is required to define the calculation of the NTS Entry Capacity Retention Charge rate and so that charges can be treated appropriately in accordance with the Licence. An associated UNC modification proposal will define the introduction of the charge whilst the proposal laid out in this document defines the rate and maps the charge on to the relevant price control terms. This would allow the mapping of the charges (and where appropriate, refunds) to TO collected revenue[*], as required, and allow the consequential recalculation of other existing charges taking into account revenues resulting from the NTS Entry Capacity Retention Charges.

Relevant Licence Objectives

3.2 The Licence requires that proposed changes to the Charging Methodology shall achieve the relevant methodology objectives.

3.3 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.

Costs Avoided by Substitution

3.4 In seeking to define a cost reflective retention charge, National Grid has estimated the potential avoided costs of entry capacity substitution.

3.5 In each QSEC auction a quantity of incremental obligated entry capacity may be released. This would result in incremental allowed revenue and an ongoing cost to the industry, were this to be met through investment and not substitution, hence this should represent the avoided cost if this incremental obligated entry capacity were to be met through substitution.

[1] UNC Modification Proposal 265 "Creation of an NTS Entry Capacity Retention charge within the Uniform Network Code".

[*] Capacity that could be substituted in a QSEC auction is restricted to non-incremental obligated entry capacity (essentially baseline capacity) and therefore any resulting revenues are treated under the Licence as TO.

3.6 The cost potentially avoided through substitution has been estimated from the average of the capitalised Licence defined revenue drivers from the two ASEPs where incremental entry capacity has been released during the current price control. This represents the costs that have been incurred i.e. the investment costs that might otherwise be avoided through substitution.

3.7 A Retainer would prevent capacity from being substituted to meet an incremental signal. If Retainers were taken out on all substitutable capacity, it would not be possible to undertake substitution and therefore the above costs would definitely have been realised in meeting an incremental signal even if substitution was in force. Therefore the amount of substitutable capacity represents the maximum chargeable quantity.

3.8 An initial unit rate for the NTS Entry Capacity Retention Charge can be calculated as the estimate of the avoided cost divided by the maximum substitutable quantity.

3.9 Appendix A outlines a potential calculation (Methodology A) which would result in an initial rate for the NTS Entry Capacity Retention Charge of £175,111 per 1 Mscm/d of capacity retained.

3.10 There are several issues and factors that would need to be taken into account to turn this “raw” charge into a cost reflective charge:

- The calculation is based on a forward projection using historic costs (i.e. historic incremental capacity releases) and therefore is not strictly reflective of the costs incurred as required of administered prices under the Licence.
- The calculation requires a probability of whether incremental obligated entry capacity would be signalled at each QSEC auction and whether this could be met through substitution or not.
- The avoided costs are based on all substitutable capacity being retained however if only half the substitutable capacity is retained there still remains a probability that substitution could occur. The determination of avoided costs is therefore imprecise.

3.11 Based on the difficulties of determining a cost reflective charge as described above, National Grid has considered an alternative approach to comply with the other relevant charging obligations. See paragraph 3.12 below.

Alternative Approach

3.12 Where transportation prices are not established through an auction, prices calculated in accordance with the methodology should properly take account of developments in the transportation business and facilitate effective competition between gas shippers and between gas suppliers subject to the cost reflectivity objective.

3.13 An alternative to considering the costs avoided by substitution is to consider a calculation based on the minimum entry capacity charge rate of 0.0001p/kWh/day that applies in all QSEC auctions. This is currently applicable at nine ASEPs and a Shipper at these ASEPs could protect capacity from being substituted by buying a sufficient number of quarters in the QSEC auction at this minimum price.

3.14 In the development of the substitution methodology statement there has been significant discussion on Shippers potentially booking a single quarter to frustrate the substitution process, therefore it would not seem consistent to base the NTS Entry Capacity Retention Charge on a single quarter booking at minimum price.

3.15 To determine the period for applying the minimum price, reference has been made to the qualifying time period of 32 quarters used within the economic test for release of incremental entry capacity.

3.16 Based on paragraph 3.15, National Grid believes that a time period of 32 quarters would be appropriate for determining the NTS Entry Capacity Retention Charge.

3.17 Appendix A also details this alternative calculation (Methodology B) which would result in a retention charge rate of £32,120 per 1 Mscm/d of capacity retained. This is around 18% of the charge rate in paragraph 3.9 above, which based on the uncertainties detailed would seem to be a more appropriate level for a retention charge. Setting the charge at this rate should also encourage uptake of this product at all ASEPs rather than only at those with high reserve prices.

3.18 National Grid would intend to keep this proposed charge rate under review, to take account of information that becomes available on the effect and likelihood of substitution.

Licence

3.19 The NTS Entry Capacity Retention Charge would need to be determined in accordance with the Charging Methodology, in compliance with the following Licence condition, in order for it to offset other NTS charges;

- Standard Special Condition C8B 2(a); Definition of TORCOMt ~ TO revenue other than that collected through capacity charges.

3.20 NTS Entry Capacity Retention Charges in regard to non-incremental obligated entry capacity that would have resulted in TO revenue would be treated as TO entry revenue; this would result in reduced (or, in respect of refunds, increased) TO Entry Commodity Charges.

Commodity Charge Impact

3.21 Shippers can calculate the approximate impact on their net entry commodity charges of the revenue received from any capacity NTS Entry Capacity Retention Charges.

3.22 Every £1m of entry revenue arising from retention charges received in relation to capacity that would have been treated as TO revenue will result in a 0.0001 p/kWh reduction in the TO Entry Commodity charge over a 12 month period.

3.23 The NTS Entry Capacity Retention Charge will be treated as income in the year in which it is invoiced*.

* Notwithstanding that a Retainer taken out in January 2010 and applicable to the March 2010 QSEC auction (plus any ad-hoc QSEC auctions) will be invoiced in July 2010 i.e. in the next formula year.

3.24 If the collection of a retention charge could not be reflected in TO Entry Commodity charges within the relevant formula year due to the timing of the invoice, the TO Entry Commodity charge rebate or the TO Entry Commodity charge credit would be used to return any TO over recovery in excess of £1m. In this instance the rebate or credit would be paid following the end of the formula year. For any TO over recovery below this £1m threshold the value would flow through TOK to the following formula year and the impact would be only on the TO Entry Commodity charge in the following formula year due to the separate treatment of over and under recovery of TO allowed revenue within the Charging Methodology.

4 Terms of the Original Proposal

4.1 Through GCM18, National Grid proposed that:

- NTS Entry Capacity Retention Charges in regard to non-incremental obligated entry capacity would be calculated based on the minimal capacity charge rate of 0.0001 pence per kWh per day applying over a time period of 32 quarters; this equates to 0.2920 p/kWh of entry capacity retained.
- NTS Entry Capacity Retention Charges and refunds in regard to non-incremental obligated entry capacity would be treated as TO revenue;
    - This would result in reduced TO Entry Commodity Charges in the case of charges incurred for retained capacity or increased TO Entry Commodity Charges in the case of subsequent refunds.

4.2 Implementation

It is proposed that these arrangements are implemented with effect from 1 January 2010 to be consistent with the approval by the Authority, if given, of the substitution methodology statement. These arrangements would therefore be applicable to the retention of capacity that could otherwise be substituted in auctions on or after 1 March 2010.

5 Representations Made

5.1 National Grid received 4 responses to its consultation on NTS GCM 18; 2 were in support, one offered qualified support and one was against. 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
BG Group	BG	Qualified Support
British Gas Trading Ltd (Centrica)	BGT	Support
Scottish and Southern Energy plc	SSE	Not in Support
Statoil (UK) Ltd	STUK	Support

Summary of Responses by Consultation Question

NTS Entry Capacity Retention Charges

National Grid proposed through methodology option B that:

- NTS Entry Capacity Retention Charges in regard to non-incremental obligated entry capacity would be calculated based on the minimal capacity charge rate of 0.0001 pence per kWh per day applying over a time period of 32 quarters; this equates to 0.2920 p/kWh of entry capacity retained.

<u>Respondents Views</u>

BG notes "As stated in our response dated 25th August to the Methodology statement, BG oppose the introduction of the Retainer approach to substitution and believe this is an inappropriate direction for the industry. However, if the methodology submitted by National Grid is approved by Ofgem, as is widely expected, then GCM18 is better than the potential alternatives (eg Methodology A, Appendix A) and hence we would reluctantly support it".

BGT stated "We are broadly supportive of the methodology changes proposed by National Grid in the GCM 18 charging methodology consultation, (subject to one comment on the level of the charge, as set out below). However, our recent response to the National Grid substitution methodology consultation set out a large number of reasons why Centrica does not believe that the proposed "retainer" approach to substitution is either appropriate or sufficiently developed. This response to the GCM 18 consultation should therefore not be taken as an indication that we support the introduction of capacity substitution in its currently proposed form, but rather that if substitution were to be introduced in the form proposed, this charging methodology appears appropriate.
The main issue we have with the GCM 18 consultation is around the level of proposed charge. According to our calculations, since two out of every 8 years until 2100 will be leap years, the proposed charge level of 0.2920p/kWh for 32 quarters will return less

[2] GCM18 consultation responses can be found at ;

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

than the minimum allowable figure of 0.0001p/kWh/day. To equal that figure, we believe that the charge rate would need to be set at 0.2922p/kWh for 32 quarters."

SSE stated "The implementation of Substitution was to avoid sterilisation of capacity and consequently ensure efficient investment. SSE is supportive of this principle but does not believe that the Retainer methodology achieves this.

STUK "supports National Grids view that of the two Retention charge methodologies proposed, methodology B offers the most logical route to formulating a charge for the retention of entry capacity.
Basing the charge on the minimum cost of securing 32 quarters of capacity as used within the economic test (generating a cost of £32,120 per Mscm/d rather than £175,111 per Mscm/d as in methodology A), would assist in encouraging interested Users participation in the scheme at all ASEPS rather that at those with high reserve prices. It would also help to alleviate the concern of the 'single quarter issue', by helping to deter Users from purchasing a single quarter of capacity which would act to protect capacity at an ASAP from substitution, as a lower cost alternative to purchasing a retainer. "

National Grid's View

National Grid welcomes the support offered by three respondents for this aspect of the proposal.

In response to the comment from BGT regarding the inclusion of a charge relating to leap years, National Grid accepts this as an appropriate change and is happy to amend the proposal so that the charge rate is set at 0.2922p/kWh to take account of leap years.

NTS Entry Capacity Retention Charges and treatment as TO revenue

Respondents Views

SSE notes "In addition, NG NTS have proposed that NTS Entry Capacity Retention Charges and refunds in regard to non incremental obligated entry capacity would be treated as TO revenue. This would result in reduced TO Entry Commodity Charges in the case of charges incurred for retained capacity or increased TO Entry Commodity Charges in the case of subsequent refunds. Although we can understand the logic we believe the added complexity will again further detract from facilitating effective competition."

STUK also "agree with National Grid that the charges and refunds associated with the use of the Retention charge should be mapped to TO revenues, as they are related to non-incremental obligated entry capacity and are treated as TO revenues under the licence"

National Grid's View

National Grid welcomes support for this aspect of the proposal from one respondent.

In response to the comment regarding increased complexity it is believed that the actual revenue streams resulting from the retention charges will be relatively small. Since these revenue streams relate to the TO, National Grid believes it necessary to map them to the TO. Not to do so would result in increased revenues to National Grid through the TO control which National Grid does not believe to be appropriate.

Implementation Date

Respondents Views

There were no specific comments in regard to the proposed implementation date.

Summary of Responses by Relevant Objectives

Reflect the Cost Incurred by the Licensee

Respondents' Views

SSE stated "The Retainer approach allows Users to pay a nominal fee for capacity that is not cost or value reflective of the reserve price of all ASEPs. As such it does not meet the primary objective of the charging methodology to reflect the costs incurred by the licensee in its transportation business and consequently does not meet the Licence Objective."

National Grid's View

The retention charge is not related to the actual provision of entry capacity. The retainer does not create rights to use capacity and Users will still pay capacity charges that result from entry capacity auctions when purchasing capacity. National Grid believes that the costs incurred in excluding unsold non – incremental obligated capacity at donor ASEPs from being substituted away are not ASEP related. The charge proposed within GCM18 has been designed to take account of developments within the transportation business and facilitate effective competition between gas shippers and between gas suppliers.

Facilitate effective competition between gas shippers and between gas suppliers

Respondents' Views

SSE stated "The Retainer payments add to the complexity of the entry regime and consequently create a barrier to new entrants. By failing to facilitate competition the proposal fails the third objective of the charging methodology, i.e. to facilitate competition."

National Grid's View

National Grid believes that the retainer charge will facilitate competition in that it will exist as a way of signalling future network requirements and avoid the substitution of capacity that is likely to be required into the future. The option to take out a retainer rather than commit to the purchase of capacity should assist Users who may need more time to finalise their planning processes. Users who are in a position to make firm commitments will take priority over those wishing to purchase retainers.

Other issues raised during the Consultation

Respondents' Views

SSE "believe the 2 Stage Auction methodology is a better solution and should be implemented for the following reasons:

1. The User commitment to buy capacity is more cost reflective being based on the ASEPs specific reserve price, rather than an arbitrary, non cost reflective, generic retainer payment.
2. It will make use of the existing QSEC process and avoid the added complexity of Retainer payments as discussed above."

National Grid's View

This is outside the scope of the charging proposal GCM18 and is covered within the Entry Capacity Substitution Methodology Statement – Formal Consultation Conclusions Document.

National Grid has reviewed its decision on the implementation of a two stage auction and still believes that the retainer approach better meets the needs of all industry parties; however, it is important to realise that the proposed Methodology Statement also facilitates the potential future introduction of a two stage auction, as it uses, as well as retainers, the level of sold capacity from the previous as well as the current auction rounds to determine the amount of capacity that is available for substitution.

6 Changes to the Original Proposal in the light of Representations Made

6.1 National Grid believes that one minor change to the proposal is required in light of responses and questions raised throughout the GCM18 consultation process. The final proposal differs from the original proposal in respect of the calculation of the charge rate, which is increased from 0.2920p/kWh to 0.2922p/kWh to reflect leap years, and is detailed in Section 7 below.

7 Final Proposal

7.1 National Grid proposes that:

- NTS Entry Capacity Retention Charges in regard to non-incremental obligated entry capacity should be calculated based on the minimal capacity charge rate of 0.0001 pence per kWh per day applying over a time period of 32 quarters; this equates to 0.2922 p/kWh of entry capacity retained.
- NTS Entry Capacity Retention Charges and refunds in regard to non-incremental obligated entry capacity would be treated as TO revenue;
    - This should result in reduced TO Entry Commodity Charges in the case of charges incurred for retained capacity or increased TO Entry Commodity Charges in the case of subsequent refunds.

<u>Implementation</u>

It is proposed that these arrangements are implemented with effect from 1 January 2010 to be consistent with the approval by the Authority, if given, of the substitution methodology statement and UNC Modification Proposal 265 “Creation of an NTS Entry Capacity Retention charge within the Uniform Network Code”. These arrangements would therefore be applicable to the retention of capacity that could otherwise be substituted in auctions on or after 1 March 2010.

8 Justification

Assessment against Licence Objectives

8.1 The Licence requires that proposed changes to the Charging Methodology shall achieve the relevant methodology objectives:

- 1) (a) Where transportation prices are not established through an auction, prices calculated in accordance with the methodology should reflect the costs incurred by the licensee in its transportation business;
- 1) (b) Where prices are established by auction, either
  - no reserve price is applied, or
  - that reserve price is set at a level best calculated to promote efficiency and avoid undue preference in the supply of transportation services; and
  - best calculated to promote competition between gas suppliers and between gas shippers;
- 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.

8.2 National Grid believes that GCM18 would satisfy the relevant objectives as it would properly take account of developments in the transportation business should the relevant UNC proposal be directed for implementation and the substitution methodology statement be approved.

Assessment against EU Gas Regulations

8.3 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.

8.4 National Grid believes that GCM18 is consistent with the principles listed above, specifically the amended methodology should;

- Be applied in a non-discriminatory manner
- Avoid cross-subsidies between network users
- Not distort trade across borders of different transmission systems.