

Modification proposal:	Modification Proposal NTS GCM18 'NTS Entry Capacity Retention Charges'		
Decision:	The Authority¹ has decided not to veto this proposal²		
Target audience:	NGG NTS and other interested parties		
Date of publication:	17 December 2009	Implementation Date:	1 January 2010

Background to the modification proposal

The December 2006 Final Proposals for the Fourth Transmission Price Control Review (TPCR4) created an obligation for National Grid Gas (NGG) to undertake entry capacity substitution (ECS). ECS is a process by which NGG moves unsold non-incremental obligated entry capacity from one Aggregated System Entry Point (ASEP) to meet the demand for incremental obligated entry capacity at a different ASEP. This is intended to minimise the amount of investment that is required to meet incremental demand and, consequently, to minimise consumer costs.

In line with its licence obligation, NGG submitted an ECS Methodology Statement and supporting documents to the Authority on 7 September 2009. We subsequently undertook an Impact Assessment³, which assessed the Methodology against the entry capacity substitution objectives of the licence. We considered carefully all of the responses to that consultation in coming to our decision, and taking account our duties and the relevant objectives, on 7 December 2009 we approved NGG's ECS methodology⁴.

The ECS methodology introduces a "retainer" as an annual product which can be taken out at any entry point with substitutable capacity. When it is requested ahead of the Quarterly System Entry Capacity (QSEC) auction, the retainer allows the specified volume of capacity to be excluded from the substitution process during the QSEC or in any other quarterly system entry capacity auction during the year. The retainer does not create rights for the user to be allocated the capacity, nor does it withhold the capacity from being offered for sale at the QSEC or any other auction. Capacity rights can only be obtained at a QSEC in the normal way, in competition with other users. There is no limit to the number of retainers that can be purchased in sequential years.

The costs of taking out a retainer on entry capacity are refunded to the party that takes out a retainer if that capacity is subsequently purchased by any user at any of the next three QSEC auctions or at AMSEC auctions, as detailed by the ECS methodology.

GCM18 defines the calculation of the NTS Entry Capacity Retention Charge (the 'retention charge') so that charges can be treated appropriately in accordance with the licence. NGG proposes to implement the charging modification from 1 January 2010.

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.

³ This document can be found at the Ofgem website: <http://www.ofgem.gov.uk>

⁴ This document can be found at the Ofgem website: <http://www.ofgem.gov.uk>

A concurrent Uniform Network Code (UNC) modification is also required to define the retention charge within the UNC⁵.

The modification proposal

In its original consultation document, NGG proposed two alternative means of deriving an appropriate retention charge level:

- The first of these estimated the avoided costs due to substitution, using the average of revenue drivers triggered in the current price control as a proxy for typical costs incurred. This suggested a retention charge of 1.5919 pence per kWh per day. However, this was rejected because it did not relate to the specific costs of a potential substitution going forward, assumed that all of the substitutable capacity is retained such that substitution cannot occur and in some instances resulted in a retention charge which would exceed the cost of simply booking capacity.
- The second of these was to consider a charge based on the minimum entry capacity charge that applies in the QSEC. This was considered more appropriate by respondents given that the retainer product is meant to be used as a signalling device rather than a means of acquiring capacity rights. NGG has adopted this approach to develop the proposal.

As a consequence, NGG's proposal is to base the retention charge on the minimum entry capacity charge rate of 0.0001p/kWh per day.

NGG also proposes to apply the retention charge over 32 quarters which is the same time period used in the economic test to determine the release of incremental entry capacity. Applying the minimum capacity charge rate over 32 quarters gives a retention charge rate of 0.2922 p/kWh⁶ or £2,922 per GWh.

The retention charge will be treated as part of transmission operator (TO) allowed revenue in line with any baseline capacity charges from the long-term auctions. Therefore, entry commodity charges will be reduced or increased⁷ depending if retention charges are paid or refunded to Shippers respectively.

Payment of the retention charge will be treated as income in the year it is invoiced. Any over-recovery of TO entry revenue as a result of paid retention charges will be resolved by NGG in line with the mechanisms defined in the Gas Transmission Transportation Charging Methodology Statement⁸.

NGG's justification of the modification proposal

NGG believes that GCM18 would satisfy the relevant objectives set out in Standard Special Condition A5(5): Obligations as regards charging methodology of the Gas Transporter Licence in that it:

- Properly takes account of developments in the transportation business should the substitution methodology and UNC265 be directed for implementation.

⁵ UNC modification 265 "Creation of a NTS Entry Capacity Retention Charge within the Uniform Network Code"

⁶ As there are 2,922 days in 32 quarters (eight years)

⁷ The retention charge is only refunded in the eventuality that the capacity is sold in the auction, so the net effect should be that the entry capacity charges received would at least offset the retention charge refund

⁸ This document can be found on National Grid's website: <http://www.nationalgrid.com/uk>

Responses to NTS GCM 18 Consultation

NGG consulted on the proposal from 11 August to 14 September 2009 and received four responses. Three of those responses were in support of implementation of GCM18 and one was against.

All respondents noted that they are against the implementation of the retainer based substitution methodology; however, this is outside the scope of the GCM18 consultation. Three of the respondents stated that if the substitution methodology is implemented, then the proposals in GCM18 are the most appropriate solution.

One respondent commented that the proposed method for calculating the retention charge will make the price of retaining capacity feasible for all ASEPs, not just those ASEPs with high reserve prices. It provides shippers with a cost effective means of signalling future intent with regards capacity, thereby lessening the likelihood of parties trying to frustrate the implementation of substitution through purchases of a single quarter of capacity at a distant period in the future to protect capacity at that ASEP.

Other respondents agreed that charges and refunds associated with the retention charge should be mapped onto TO revenues.

One respondent noticed an error in the calculation of the proposed charge. The GCM18 consultation paper⁹ stated a proposed charge level of 0.2920 p/kWh. The respondent noticed this failed to take into account the effect of leap years within the 32 quarters the charge is based over. This increased the level of the charge to 0.2922 p/kWh. NGG acknowledged this error and corrected the charge level in the final consultation report.

The respondent who was not in favour of the implementation of GCM18 stated it is not cost reflective or reflective of the value of reserve prices as it allows users to pay a nominal fee for capacity.

The Authority's decision

The Authority has considered the issues raised by the modification proposal and the Conclusions Report dated 19 November 2009. The Authority has considered and taken into account the responses to NGG's consultation. The Authority has concluded that:

- 1. Implementation of the modification proposal will better achieve the relevant objectives of the Methodology¹⁰; and;**
- 2. Deciding not to veto the proposal is consistent with the Authority's principal objective and statutory duties.**

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 the costs incurred by the licensee in its transportation business

We consider that the proposed retention charge better achieves the requirements of this objective.

⁹ This document can be found on National Grid's website: <http://www.nationalgrid.com/uk>

¹⁰ As set out in Standard Special Condition A5(5) of NGG's Gas Transportation Licence

We note the concern of one respondent to the consultation that the retention charge is not cost reflective or value reflective of the reserve prices for capacity at the QSEC auction.

Paying to retain capacity does not give a user the same rights as purchasing capacity at the QSEC auction i.e. the retainer does not give a user a right to flow gas. Retained capacity is still available for purchase at the QSEC auction at the reserve prices set out in the auction invitation letter.

There are a number of different approaches that could have been used by NGG to derive a figure for the level of the charge for retaining capacity.

In keeping with the aim of introducing ECS by means of a 'soft landing' approach, NGG has determined charges in a way that is pragmatic and is expected to avoid a level of charges which might either limit the beneficial effects of the retainer product or undermine the effect of the substitution policy.

The purpose of the retention charge is to send a user commitment signal to NGG linked to the future requirement for capacity at an ASEP, so that it is not substituted away. The level of user commitment required for the retention charge is commensurate with the amounts paid for pre-works agreements for connections to the NTS; in both cases, if the user does not follow up on the initial commitment, the amounts paid are at risk.

We note that NGG has undertaken to keep the level of the retention charge under review in order to gauge its effectiveness. We have asked NGG to provide a report summarising the experience of the initial application of ECS and have requested NGG to set out areas where the ECS methodology requires further development. We would expect this report to consider whether, in the light of experience, a change might be required to the level of the retainer charge.

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

The ECS methodology approved on the 7 December 2009 allows users to signal where they do not want capacity to be available for substitution by the purchase of a capacity retainer. We have also approved UNC265 which defines the retention charge as a transportation charge in the UNC.

It is our view that GCM18 properly takes account of these developments in the transportation business. GCM18 will facilitate the introduction of a retention charge by setting out how the charge will be calculated and how NGG will administer revenues associated with the payment of the retention charge. Therefore, we consider GCM18 will achieve this relevant objective.

SSC A5(5)(c) that, so far as is consistent with sub-paragraphs (a) and (b), compliance with the charging methodology facilitates effective competition between gas shippers and between gas suppliers

As set out in our decision to approve the ECS methodology, substitution facilitates competition by broadening the pool of shippers that can bid for a given tranche of unsold entry capacity. However, during the discussions on the development of the ECS methodology, it was noted that currently a single quarter booking of capacity at a distant period in the future can be used to preserve baseline capacity from substitution at an ASEP. Such a strategy can create inefficiencies in the use of the

NTS by sterilising capacity at ASEPs, frustrating the implementation of substitution. The provision of new capacity through substitution has advantages in that it provides greater certainty on the timing of the availability of capacity, which should be beneficial for competition. As noted by a respondent, the provision of a suitably priced retainer product should minimise the likelihood of single quarter bookings, thereby facilitating the implementation of entry capacity substitution and therefore facilitating competition.

Decision notice

In accordance with Standard Special Condition A5 of NGG NTS's Gas Transporter Licence, the Authority has decided to not to veto modification proposal GCM18: NTS Entry Capacity Retention Charges.

Stuart Cook
Acting Senior Partner, Transmission and Governance

Signed on behalf of the Authority and authorised for that purpose