

Modification proposal:	Modification Proposal NTS GCM 19 'Removal of NTS Daily Entry Capacity Reserve Price Discounts'		
Decision:	The Authority¹ has decided to veto this proposal²		
Target audience:	NGG and other interested parties		
Date of publication:	30 July 2010	Implementation Date:	N/A

Background to the modification proposal

Users wanting to bring gas onto the National Transmission System (NTS) have to purchase the appropriate volume of NTS entry capacity from National Grid Gas (NGG). NTS Entry capacity is sold through a series of auctions spanning a range of time periods; from quarterly blocks up to 17 years ahead, right down to within day sales.

NGG recovers the entry portion of its Transmission Owner (TO) allowed revenue through TO entry capacity and commodity charges. NGG receives TO revenue for entry capacity through the entry capacity auctions (except for within day sales of NTS entry capacity, which are counted as System Operator (SO) revenue); the commodity element of revenue is derived from a volume-based charge which seeks to ensure that NGG achieves its TO allowed revenue, should there be a shortfall in the capacity revenue (relative to the TO allowed revenue).

The auctions have a reserve price which users' bids must equal or exceed in order to be allocated capacity. This reserve price is calculated by application of the gas transmission transportation charging methodology, and is based on the Long Run Marginal Cost (LRMC) at each entry point. The reserve price for a day's worth of NTS entry capacity is equal to 1/365th of the annuitised and adjusted³ LRMC.

NGG offers discounts to the reserve price at auctions for daily firm entry capacity products, as follows:

- Day ahead auction: 33.3% discount on the reserve price; and
- Within day auction: 100% discount on the reserve price i.e. a zero reserve price.

The reserve price for daily interruptible entry capacity is also set at zero. Users pay the price at which entry capacity has been allocated for, in all auctions of NTS entry capacity; the price is not adjusted for inflation if bought in previous years.

In recent years, the commodity element of the TO revenue recovered by NGG has been growing, such that it currently constitutes the majority portion of the recovered revenue. Some Users have expressed concern about the level and volatility of the commodity charge. NGG instigated a review of the entry charging arrangements to see if an alternative charging scheme which would address these concerns could be devised⁴.

The review group identified three key sources for low auction revenues, these were:

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 These include adjustments so that a 50:50 split between entry and exit charges is maintained and that a minimum reserve price of 0.0001 p/kWh/day is applied to avoid negative reserve prices.

⁴ See 'Discussion report: Modification Proposal to the Gas Transmission Transportation Charging Methodology & Associated UNC and Licence Issues, NTS GCD 08R: NTS Entry Charging Review' dated 15 March 2010 & 'Review Group Terms of Reference' both published on NGG's website, www.nationalgrid.com

- Price paid: resulting from the reserve price discounts for daily entry capacity;
- Model changes: the Transportation model replaced the previous network model (Transcost) in 2007⁵. Prices based on Transcost were generally lower than those set via the Transportation model. As entry capacity can be bought up to 17 years in advance through auctions the lower prices set via Transcost will be important for a number of years; and
- Peak amount of entry capacity procured: NGG noted that if entry capacity was procured at prevailing reserve prices at the forecast level of supply published in the Ten Year Statement (TYS)⁶ then NGG would over-recover its TO allowed revenue. However, Users do not book NTS entry capacity up to this level ahead of the gas day, i.e. before the reserve price is set at zero.

The modification proposal (“the Proposal”)

The review group developed a number of proposals and submitted these to Ofgem for consideration.

The modification proposal GCM19 would remove the discounts on the reserve price for the daily entry capacity auctions (both day-ahead and within day) such that the reserve price for daily entry capacity auctions would be equal to the reserve price in the entry capacity monthly auctions.

With a view to facilitating the implementation of GCM19, the review group also developed two UNC modification proposals which are also with Ofgem for decision, these are:

- UNC284: would facilitate implementation of GCM19 by removing the requirement for a zero auction reserve price for within day sales of firm NTS entry capacity from the UNC; and
- UNC285: would restrict the release of Use-It-Or-Lose-It (UIOLI) interruptible entry capacity⁷ to situations where at most ten per cent of firm entry capacity remains unsold after the rolling monthly entry capacity auctions.

The review group also considered a further development that may be necessary, which was for revenue from within day sales to be transferred from the SO allowance to the TO allowance (referred to in Ofgem’s Impact Assessment as ‘Proposal 3’). However, no proposal has been developed for this.

This decision letter concerns the proposal GCM19 only.

Justification of the modification proposal

NGG considers that GCM19 better achieves the relevant gas transmission transportation charging methodology objectives⁸ in that:

⁵ See Ofgem decision on GCM01 ‘Alternative methodologies for determination of NTS entry and exit capacity prices’, which was published on Ofgem’s website www.ofgem.gov.uk on 24 April 2007 with reference number 94/07. GCM01 implemented the Transportation model with effect from 1 October 2007.

⁶ The Ten Year Statement (TYS) is published by NGG annually. It sets out the forecast of NTS usage and likely developments on the NTS.

⁷ Under UNC provisions NGG is required to offer unused NTS entry capacity (the UIOLI amount) as interruptible NTS entry capacity. The UIOLI amount is the average unused NTS entry capacity i.e. firm NTS entry capacity sold minus the proportion of that NTS entry capacity used to flow gas over a recent 30 day period.

⁸ As set out in Standard Special Condition A5(5) ‘Obligations as regard charging methodology’ of NGG’s NTS licence.

- Cost reflectivity is improved: NGG argues that if daily entry auction reserve prices are discounted, and allowed revenues that are not collected from auctions are collected via the TO entry commodity charge, then the TO entry commodity charge may not be cost reflective. NGG argues that removal of the discounts via GCM19 would therefore improve cost reflectivity of TO entry commodity charges;
- Efficiency is promoted: NGG argues that removing short-term entry capacity discounts will incentivise greater procurement of long-term entry capacity, with the implication that a more appropriately sized NTS would be developed. NGG argues that discounted or zero short-term reserve prices are attractive when NTS entry capacity is perceived to be plentiful and so discourage long-term signals for new NTS entry capacity, but when entry capacity becomes scarce this can lead to unpredictable NTS entry capacity prices at auction and more frequent scale back of interruptible NTS entry capacity until incremental NTS entry capacity is signalled and provided;
- Undue preference is avoided: NGG argues that while those booking short-term NTS entry capacity receive discounts, and the shortfall in auction revenue is recovered by all Users, then those booking in the short term are cross subsidised by those booking long-term. NGG also argue that there is potential undue discrimination against new NTS entry points which have no access to discounted NTS entry capacity. Another point made by NGG is that removal of discounts via GCM19 and application of LRMC based prices should ensure that locational prices avoid undue preference. NGG is of the view that zero reserve prices at all NTS entry points in the short-run allows users at non-competitive entry points to buy NTS entry capacity cheaply and costs are potentially passed on to other system users; and
- Competition is promoted: NGG argues that reserve price discounts inhibit secondary trading at NTS entry points and that removal of discounts via GCM19 will encourage more secondary trading.

Responses to NTS GCM 19

NGG consulted on the Proposal in March 2010 and received eight responses, one of which was confidential. Five of the eight respondents supported implementation of GCM 19 whilst the other three did not.

Ofgem impact assessment

On 24 June 2010 Ofgem published its Impact Assessment⁹ on GCM19, UNC284, UNC285 and Proposal 3. We received twelve responses¹⁰, of which two were confidential. Half of the respondents, in general, supported implementation of the proposals (including GCM 19); the other half did not.

The main themes coming out of the consultation are:

- i. Impact of proposals;
- ii. Marginal cost;
- iii. Security of supply;
- iv. European law; and
- v. Competition.

⁹ See 'Review of NTS entry charge setting arrangements – Impact assessment', which was published on Ofgem's website www.ofgem.gov.uk on 24 June 2010, with reference number 77/10.

¹⁰ The non-confidential responses can be found under 'Review of NTS entry charge setting arrangements – Impact assessment', which was published on Ofgem's website www.ofgem.gov.uk on 24 June 2010, with reference number 77/10.

The annex provides a more detailed summary of the responses.

Impact of proposals

A number of respondents agreed with NGG's analysis that the impact of the proposals on entry capacity auction revenue would be an increase in the range of £3 million to £71 million. One respondent recognised that this was dependent on the degree of secondary trading which another thought the proposals would stimulate. One respondent thought that the impact of the proposals on TO commodity charge i.e. a decrease of between 0.0004 p/kWh and 0.0082 p/kWh (or between 2 and 42 per cent of the current charge), was modest to significant. Some other respondents disagreed, they argued that the impacts of removing the discounts on auction revenues do not account for more long-term bookings that may result from transfer, trade and substitution and that more entry capacity will be procured at the generally higher prices set via the transportation model which was introduced in 2007.

Some respondents considered that despite the minimal impact of the proposals they were a necessary first step in increasing auction revenues and reducing the TO commodity charge.

Marginal cost

A number of respondents considered that the use of Short-Run Marginal Costs (SRMC) of zero within-day auctions was appropriate noting arguments that if there are limited costs in making this entry capacity available within-day then the reserve price should reflect this. The price accounts for the risk that entry capacity may not be available in the short run and a flat reserve price as suggested by the proposals would not be cost reflective.

Other respondents disagreed arguing that entry capacity is not currently scarce and so there is no risk that it will not be available within-day. They considered that the rights of users holding entry capacity procured up to 17 years in advance and within-day are the same. The bid price is less than the value that users measure the entry capacity at and that the SRMC is only low because the NTS exists as a result of user commitment signals. One respondent noted that the total marginal cost signal that users face is the entry capacity plus commodity prices and considered Ofgem's argument inconsistent for users to face a total marginal cost (zero entry capacity plus commodity) greater than the SRMC (zero entry capacity) under the status quo but not under the proposals.

Another respondent noted that storage users booking short-term entry capacity are not contributing to TO revenues as they do not currently pay TO commodity charges. Another questioned why a zero reserve price would not be appropriate for monthly entry capacity products.

Security of supply

A number of respondents considered that the status quo posed concerns for security of supply as opposed to implementing the proposals. They argued the current arrangements reduce the attractiveness of GB in instances where a user has flexibility over which country to deliver gas. One noted that UKCS gas landing at Bacton has two main options within-day; either to deliver gas to National Balancing Point (NBP) and incur commodity charges or deliver gas to the continent via Interconnector UK (IUK) and avoid the high

commodity charges by opting to pay the short-haul charge. It argues that the user will chose not to import to GB as a result of the high TO commodity charges.

Another respondent conducted two pieces of analysis on pricing and security of supply. In the first analysis they compared the historic price differential between the NBP and Zeebrugge gas prices with the current level of commodity charges levied in GB (both SO and TO). It then compared the differential if the TO commodity charge was set at a level to collect ten per cent of entry revenues. It assumed that if the NBP price was above the Zeebrugge price plus the commodity charges gas would flow to GB. It concluded that reducing the TO commodity charge to a level such that it only accounted for 10 per cent of allowed entry revenues would increase the number of days when gas would flow to GB. In the second piece of analysis it concluded that the NBP/Zeebrugge price differential has a low correlation with the TO commodity charge. From this it concluded that if the high TO commodity charge resulted in raising the NBP price then continental prices will take the lead from NBP price and also raise their prices. It concluded further that this means that the NBP would not be able to attract gas, relative to the Continent, as a result of the TO commodity charge being passed on at the NBP.

A number of respondents disagreed that the status quo posed concerns for security of supply and thought that the proposals would reduce the attractiveness of GB for imports by reducing the short-term entry capacity available to users, thus making investments and marginal fields less viable. They also considered that the NBP price as opposed to the TO commodity price was the important determinant of whether gas lands at GB. Another respondent argued that long-term investment is driven by the gas price rather than commodity charges, so that volatility in TO commodity charge was not a major deterrent to investment.

European law

Some respondents considered that the status quo may not be consistent with EU law. They argued that Ofgem's assessment of the status quo against EU legislation implied that the use of auctions overrides other EU requirements (such as ensuring tariffs are cost reflective and avoid cross subsidies) which they felt may not be the correct interpretation. Another noted the requirement in EU regulations¹¹ that tariffs be set separately for every entry and exit point and that this may not be the case for entry points within-day. It was also raised that the current arrangements are contrary to EU requirements which require charges to encourage users to book capacity according to their needs.

Competition

Some of those respondents who were against implementation of the proposals argued that the zero reserve price in the status quo allows the market to clear and determine the price and removes the price differential between entry points within-day.

Some of the respondents who supported the proposals argued that users at non-competitive entry points acquire entry capacity and pass the cost onto others. One respondent did not agree that there were 'low-value' users who would be disadvantaged from removing discounts and argued that such users can pass on the daily entry capacity charges at the NBP.

¹¹ See Article 13(1) of Regulation (EC) No 715/2009 of the European Parliament and of the Council of 13 July 2009 on conditions for access to the natural gas transmission networks and repealing Regulation (EC) No 1775/2005 on www.eur-lex.europa.eu

A number of respondents argued that the lack of stable and predictable prices results in a high volatility risk premium being passed on to consumers with fixed price contracts.

Other points

A respondent noted that the high TO commodity charge could result in more users opting for the 'short-haul' tariff which would result in the fixed allowed revenue being collected from fewer users, since revenues from the 'short-haul' tariff are considered as SO revenues and not TO revenues, and a downward spiral of increasing TO commodity charges.

One respondent sought that Ofgem acknowledge the significance of the issues around the low auction revenues and provide direction and a timetable for further discussions should the proposals be vetoed.

The Authority's decision

The Authority has considered the issues raised by the modification proposal and the Conclusions Report dated 30 April 2010. The Authority has considered and taken into account the responses¹² to NGG's consultation together with the responses to the impact assessment carried out by Ofgem¹³. The Authority has considered the relevant objectives and concludes that implementation of the modification proposal will not better facilitate the achievement of the relevant objectives of the Charging Methodology¹⁴.

Reasons for the Authority's decision

The main focus of the review group was to endeavour to maximise the proportion of allowed TO entry revenue recovered via capacity charges whilst achieving the charging methodology objectives. The Authority's assessment of any proposal to modify the charging methodology is to consider whether it will better facilitate the achievement of these charging methodology objectives. We consider the proposals against each of these objectives below.

SSC A5(5)(aa) that, in so far as in respect of transportation arrangements are established by auction, either: (i) no reserve price is applied, or (ii) that reserve price is set at a level - (I) best calculated to promote efficiency and avoid undue preference in the supply of transportation services; and (II) best calculated to promote competition between gas suppliers and between gas shippers

Taking account of the views of respondents, we consider that the following issues are relevant to consider against this objective:

1. Consistency with the principles of marginal cost pricing;
2. Impact on competition;
3. Undue preference for users of daily capacity;

¹² NGG modification proposals, modification reports and representations can be viewed on the NGG website at www.nationalgrid.com

¹³ See 'Review of NTS entry charge setting arrangements – Impact assessment', which was published on Ofgem's website www.ofgem.gov.uk on 24 June 2010, with reference number 77/10.

¹⁴ 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

4. Extent to which GCM19 would increase long term bookings;
5. Extent to which GCM19 would impact on volatility of charges

Marginal cost pricing

In a natural monopoly such as gas transmission the charging methodology objectives aim to replicate the conditions in a competitive market i.e. to facilitate the market clearing at pricing levels which do not reflect artificial constraints and restrictions. In such a competitive market for gas transmission capacity, NGG would increase its supply of capacity until the Marginal Cost (MC) of an additional unit of capacity equals the Marginal Revenue (MR) that it receives. Similarly users will procure increased capacity until the Marginal Benefit (MB) of the capacity to them equals the MC. Where the MB is greater than the MC the user can benefit further by procuring more capacity. Setting the floor price equal to the MC of providing capacity is an important mechanism to allow the market to determine the price which efficiently allocates capacity to the benefit of both NGG and users – it will help to bring into balance the level of capacity that NGG is willing to provide with the level of capacity that users are willing to procure. In the long term this is useful in developing an efficiently sized NTS.

However, in the market for gas transmission entry capacity amounts are delivered in 'lumpy' investments such that the quantity provided by NGG from a particular investment may not exactly match the level demanded by users. In other circumstances the level of capacity required by users can fall relative to the amount anticipated to be required at the time of the original investment. This is evident in the current NTS where the capacity obligations on NGG exceed the peak usage. In circumstances where there is substantial excess capacity theory predicts that the price of capacity should fall towards the Short Run Marginal Cost (SRMC) of providing this capacity. Where entry capacity within-day is already provided, the cost of making this capacity available in the short-run is relatively low. Under competitive market conditions the price for such entry capacity would equate to the SRMC of making this capacity available.

Reflecting the fact that the SRMC of daily entry capacity is relatively low, Ofgem considers it appropriate that the reserve price for such capacity is lower than the reserve price for longer term capacity i.e. the Long Run Marginal Cost (LRMC). GCM19 would move further away from this position by basing the daily entry capacity auction reserve prices on the LRMC.

Competition

We mentioned previously that the charging methodology objectives aim to replicate the conditions in a competitive market whereby an environment is created which facilitates the market clearing. We consider that the setting of artificial barriers such as a floor price which was higher than the SRMC would have an adverse impact on competition. As GCM19 would increase the reserve price in daily auctions to the LRMC Ofgem considers that this would create an artificial barrier to market participation and might prevent the use of the system by participants who would be content to pay more than the SRMC, but less than the LRMC. In addition to working against competition, this withholding of capacity would work against the efficient use of the gas transmission system.

Undue preference

A number of respondents considered that the current arrangements creates cross subsidies between users booking capacity in the longer-term auctions to those booking in

the short-term auctions such that there is an undue preference given to those booking short-term capacity. For this to be the case it would imply that the cost of capacity booking in the short-term auctions significantly differed from the SRMC. For the reasons set out above we expect the SRMC to be relatively low compared with the LRMC. Therefore there is a strong case that the existing arrangements, with discounts on short-term reserve prices, results in charges which are closer to the MC of providing that capacity in the short-term. Moving to LRMC for short-run capacity is certain to impose artificially high costs on procurements of short term services. Ofgem therefore does not agree that the current arrangements give undue preference to those booking capacity in the short-term.

Long-term bookings

We consider that the main effects of GCM19 would be to reduce the volume of short-term bookings, increase the secondary market and incentivise shippers to procure short-term entry capacity at the day-ahead stage as opposed to within-day¹⁵. Ofgem does not consider that long-term bookings will materially increase as a result of GCM19. With a non-zero daily entry capacity reserve price users will utilise the short-term auctions to refine their capacity holdings for the days when their longer-term capacity bookings are insufficient for their anticipated flows.

Volatility of charges

We also consider that the impacts of GCM19 on the TO auction revenues would be at the lower end of the range estimated by NGG, i.e. an increase of between £3 million and £71 million, due to the stimulation of the secondary market (we also note that these may over-estimate the individual impact of GCM19 as this estimates the combined impacts of a suite of proposals, one of which is GCM19, and do not account for the potential increase in long and medium-term entry capacity bookings resulting from trade, transfer and substitution). An increase in auction revenues of £3 million translates to a decrease in TO entry commodity charge of around 0.0004 p/kWh. This is relatively low compared to the current level of the charge at 0.0194 p/kWh and we consider it would be unlikely to have a significant effect on the level and volatility of the TO entry commodity charge. Furthermore, the extent of the estimated impact of GCM19 by NGG gives scope for considerable volatility to remain, and we note that the proposal would not prevent the principal source of charging volatility in recent years from continuing to arise; namely, short-run entry capacity constraints leading to spikes in the level of entry capacity revenues collected.

The maximum annual variability in the TO commodity charge observed was 0.0164 p/kWh in 2006/7¹⁶. The range of annual variability in the day-ahead gas prices is from 0.71 to 6.51 p/kWh. As the variability in gas price is accounted for in fixed-price contracts we consider that users are better able to factor TO commodity charge variability into their fixed-price contracts.

¹⁵ With flat reserve prices at the day-ahead and within-day stages users will receive no price incentive favouring either day. However, all revenue from entry capacity bought at the day-ahead stage will be returned to the shipper community via lower TO entry commodity charges. Whereas without proposal 3 being implemented the revenues from within-day sales will contribute to higher SO allowed revenues for NGG.

¹⁶ This situation arose from the TO commodity charge being set at zero from April 2006 to September 2006 and the estimated shortfall in TO auction revenue was therefore fully recovered through TO commodity charges set at 0.0164 p/kWh from October 2006 to March 2007.

We note the concern that short-haul tariffs with high TO commodity charges could result in a downward spiral of increasing TO commodity charges and note NGG's current work at reviewing the short-haul charge so that it is set at an appropriate level.

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

As capacity charges are set by auction this objective has a lesser role in assessing the current modification proposal than SSC A5(5)(aa). However, efficient pricing does not always create circumstances which ensure the recovery of allowed revenues. In the current regime, the shortfall in allowed revenues are recovered via the TO commodity charge. This is a per unit charge based on recovering the forecast shortfall from the volume of gas flowed by all users at entry points, except at storage¹⁷ and short-haul sites¹⁸.

We note that no analysis has been done as part of the review as to what the appropriate level of commodity charge should be and there was not a consistent view on the level of the commodity charge from respondents to our Impact Assessment; there is uncertainty that implementation of GCM19 would lead to an improvement in the reflectivity of the TO commodity charge. Furthermore, we note the difficulty in setting a commodity charge that is reflective of appropriate costs due to its design as a shortfall recovery mechanism.

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

Ofgem accepts that since the introduction of the clearing allocation requirement in 2002 the levels of competition for capacity in the short-term may have reduced and this may contribute to low levels of auction revenue which may, in turn, have led to an increase in the volatility of commodity charges. However, GCM19, which aims to address this particular development in the transportation business, does not account for other developments such as the fact that NGG's obligation to release capacity is currently above the level of peak usage. A further development which also requires consideration is the impact of substitution. It is anticipated that substitution should allow for incremental capacity requests to be met from the current excess in capacity obligations over peak supply. This would lead to a 'tighter' network which could encourage more long-term bookings. If GCM19 were implemented then these factors in combination could create more volatility in the TO commodity charge.

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

We note that the arguments made regarding competition have been included under the heading for SSC A5(aa).

Summary

¹⁷ We note that storage users do not current pay TO entry commodity charges nor SO commodity charges.

¹⁸ An optional 'short-haul' tariff was made available to users in lieu of paying the TO and SO commodity charges. The rationale was that the short-haul tariff reflects more accurately the costs of transporting gas from large entry terminals to nearby exit points. It was argued that this removes the incentive for the construction of independent pipelines and thus avoiding NTS charges, which could be inefficient outcome for all NTS users. Short-haul allocations are the flows of gas between entry and exit points where users have opted to pay the 'short-haul' tariff.

Ofgem considers that GCM19 would not better facilitate the relevant objectives as it would move to using the LRMC signal as the basis for daily entry capacity reserve prices, and in our view this would be to the detriment of efficient allocation of short-run entry. Furthermore, we consider that the proposals would have limited impact on auction revenues and the TO commodity charge which is the main aim of the proposal. Given the significant uncertainty around the level of change that could be brought about by this proposal, we do not have confidence that implementing this proposal would achieve the intended aims or bring about the behavioural changes that its supporters hoped for.

However in rejecting the proposal, we do not discount a number of the issues which the proposal has revealed to be important. NGG has submitted the proposal to address perceived problems with the level and volatility of TO entry commodity charges. We have explained why we do not consider that the proposal would achieve what it sets out to do, and why we have a principled opposition to the use of LRMC pricing as the basis for short-run entry capacity auction reserve prices, but in evaluating the proposal we consider that NGG could have done more to consider what cost reflective commodity and entry capacity charges may be. The proposal states a concern that TO entry commodity charges may not be cost reflective, and that day ahead and within day entry capacity charges are not cost reflective, but does not consider at a conceptual level the allowed revenues that capacity and commodity should collect and on what basis scaling to collect total allowed revenues should take place. In developing future proposals if NGG consider that this is not the case, and that it is not cost reflective to recover a high proportion of costs from commodity charges, we would encourage them to consider where this balance ought to lie.

Other considerations

The responses to the impact assessment considered a couple of themes in addition to those explicitly captured in the charging methodology objectives which we consider below.

Security of supply

We note that some of the respondents argued that the status quo was detrimental to GB attracting imports of gas which has implications for security of supply. We noted previously that we do not consider that GCM19 would have a significant impact on auction revenues and the level of the TO commodity charge. Therefore, we do not consider that there would be any material impacts on the relative attractiveness of GB as a market for gas and therefore on security of supply.

EU law

The current applicable EU regulations that must be complied with are set out in EU Regulation (EC) No 1775/2005¹⁹. This will be repealed by Regulation (EC) No 715/2009²⁰ which applies from 3 March 2011. We note that Article 3(1) of Regulation EC No 1775/2005 places a number of requirements on tariffs, or their methodologies, applied by transmission system operators including reflecting actual costs, avoiding cross

¹⁹ See Regulation (EC) No 1775/2005 of the European Parliament and of the Council of 28 September 2005 on conditions for access to the natural gas transmission networks on www.eur-lex.europa.eu

²⁰ See Article 14(1)(b) of Regulation (EC) No 715/2009 of the European Parliament and of the Council of 13 July 2009 on conditions for access to the natural gas transmission networks and repealing Regulation (EC) No 1775/2005 on www.eur-lex.europa.eu

subsidies, being transparent, etc. However, this same article also allows for tariffs to be determined through market based arrangements such as auctions. For the reasons set out above, we do not consider there to be cross subsidies in the current arrangements and the tariffs are transparent etc.

The current applicable EU regulations do not require tariffs to be set separately for every entry and exit point. This will be required following application of Regulation (EC) No 715/2009 from 3 March 2011. Despite this Ofgem notes that the current arrangements of a zero reserve price based within-day auction for entry capacity at each entry point will allow for entry point specific demand and supply factors to determine the actual tariff which capacity is bid and allocated at.

On this basis Ofgem is satisfied that our decision is consistent with current obligations on NGG under EU law but note that NGG should ensure that it complies with any developments in this area to the extent that any requirements are directly applicable as a matter of EU law.

Combined proposals

The role of the Authority as regards assessing modification proposals to the charging methodology is to assess whether the proposal on its own better facilitates the relevant charging methodology objectives. This decision is therefore concerned with the vetoing of GCM19 on its own merit. However, we note that the impact assessment considered the suite of proposals and the various combinations of these. In vetoing GCM19 we note that this has implications for the other two modification proposals with us for decision (namely UNC284 and UNC285) and we aim to publish our decision on these shortly.

Way forward

Ofgem is mindful that a number of industry parties consider that the current charging arrangements are flawed, which has led to the development of GCM19 and associated proposals. Notwithstanding this veto of GCM19, we are keen to ensure that further discussions around the issues raised by the proposal take place. These discussions will have to consider, amongst other things, EU developments on charging resulting from the new EU regulations which come into effect from 3 March 2011 which include the development of EU network codes on capacity allocation, congestion management and harmonised transmission tariff structures. We also noted in this letter that NGG is currently undertaking a review of short-haul arrangements which we encourage NGG to progress.

In March 2010, Ofgem published its final proposals from the Code Governance Review. Amongst other things, these proposals envisage the scope for Ofgem to initiate Significant Code Reviews (SCRs) to address complex changes to the rules and charging arrangements. Ofgem will consult on areas of the current arrangements which might be candidates for a SCR. We will give consideration, in light of industry and stakeholder views, to whether the perceived issues associated with the current gas charging regime might justify consideration of the gas charging regime through the SCR process.

Some respondents expressed disappointment that the Ofgem Impact Assessment expressed a minded-to view to reject the proposal given Ofgem's presence at the development group meetings. For the avoidance of doubt, we confirm that Ofgem's presence and participation in such meetings does not constitute any form of approval.

Decisions on charging modifications are made by the Authority following careful and full consideration of the proposal presented to us and the views of interested parties against the relevant objectives and any applicable, statutory requirements. Where required by the Utilities Act 2000, we undertake an Impact Assessment, and reach a decision after completion of the Impact Assessment. The Authority does not make its decision until completion of the relevant process and no comment or action by any Ofgem representative can be interpreted as or substituting the decision that the Authority will make.

Notwithstanding this, the Ofgem representative at industry meetings may offer views to the group in order to assist the group in its deliberations; it is our understanding that interventions of this nature were made during the development of GCM19 and the related proposals. For example, Ofgem representatives noted at the review group that a convincing case would need to be required to move away from the current licence obligation on NGG holding a clearing allocation. Ofgem representatives also requested for consultation responses to the discussion paper²¹ to address what issues and problems there were with having high TO commodity charges.

The participation of Ofgem in long-running industry discussions cannot be viewed as indicative of our support for the proposal which is the subject of debate. Any interested party who chooses to rely on comments or actions of Ofgem representatives prior to a decision, and who bases any commercial decisions on such comments, does so entirely at their own risk.

Decision notice

In accordance with Standard Special Condition A5 of NGG's Gas Transportation Licence, the Authority has decided to veto modification proposal GCM 19: Removal of NTS Daily Entry Capacity Reserve Price Discounts.

**Stuart Cook
Senior Partner, Transmission & Governance
Signed on behalf of the Authority and authorised for that purpose.**

²¹ See 'Discussion Document: Modification Proposal to the Gas Transmission Transportation Charging Methodology & Associated UNC and Licence Issues – NTS GCD08: NTS Entry Charging Review' published on the NGG website www.nationalgrid.com on 18 January 2010.

Appendix 1 – Summary of responses to impact assessment

We received twelve responses²², of which two were confidential. Six respondents were, in general, in support of implementing the proposals (including GCM19) and six were, in general, not in support of their implementation.

CHAPTER: Three

Question 1: Do you agree with NGG's analysis on the impacts of removing the reserve price discounts?

Three respondents agreed with NGG's analysis on the impacts of removing the reserve price discounts, one of which noted that the impact was dependent on the degree of secondary trading resulting. Another noted updated analysis by NGG which shows the minimum impact of proposals to be an increase in auction revenue of £11m in 2009/10, as opposed to £3m quoted for 2008/9. They argued that this shows increased reliance on short-term capacity.

Two respondents did not agree with NGG's analysis. One thought that historical flows and bookings should not be used to forecast future revenues. The other thought that the analysis overestimates the impact of the proposals as transfer, trade and substitution will encourage long-term bookings as there is no guarantee that short-term capacity will be available and more capacity will be secured at the generally higher prices resulting from the transportation model.

CHAPTER: Four

Question 1: Do you agree with our analysis of the proposals against the appropriate objectives?

Three respondents considered that basing the reserve price for daily capacity on the short-run marginal cost (SRMC) price is appropriate as the reserve price should reflect the limited cost of making capacity available in the short term. Another agreed that sometimes capacity can be provided at no marginal cost but this does not mean that capacity should routinely be provided at a zero reserve price. Another considered that the price accounts for the risk taken by short-term users that capacity may not be available.

Another disagreed and considered that buying capacity 15 years in advance does not confer different rights to those buying capacity in the short term and that currently capacity is not scarce so the risk of it not being available is limited. Another respondent considered that this results in shippers bidding for capacity at zero price when they value it much higher. Whilst another considered that having the capacity physically in place does not guarantee gas will flow.

Another respondent thought that using the SRMC overlooks the fact that the SRMC is only low because the NTS exists due to long term signals for capacity. Those disagreeing with Ofgem's conclusions thought that SRMC pricing may not be representative of all consumer interests. They questioned whether the status quo allows for more efficient and economic allocation of capacity given: under-recovery; the cross subsidies (from those booking long-term to those booking short-term, from firm to interruptible); discrimination (from users at new entry points to those at existing entry points); the lack of stable and predictable prices (the uncertainty over which results in

²² These can be found under 'Review of NTS entry charge setting arrangements – Impact assessment', which was published on Ofgem's website www.ofgem.gov.uk on 24 June 2010, with reference number 77/10.

higher NBP prices which are passed on to consumers) and lack of long term signals - resulting in short-term constraints.

Another respondent disagreed with Ofgem that availability of short-term capacity should not be curtailed by the imposition of artificial price barriers. They argued that short-term capacity will still be available but at a cost to users. This respondent referred to the analysis Ofgem published in the impact assessment showing that there would be no instances where UIOLI capacity or within-day capacity would not be made available had UNC285 been implemented in the last three winters. It noted the MC that shippers face has two elements (i) cost of short-term capacity booking (ii) commodity charges (both SO and TO), and that at the margin shippers will normally flow gas when the benefits exceed the total MC they face. They concluded that a high TO commodity charge has a strong influence on gas dispatch decisions which could result in a bias against imports.

Of those respondents agreeing with Ofgem, they noted that the proposals reduce viability of investments in United Kingdom Continental Shelf (UKCS) exploration and production, attractiveness of the GB market for imports and market liquidity by reducing volume of short-term capacity available to traders. Others noted that marginal and declining fields which have variability in terms of production and do not book long-term will not be viable which in turn will incur possible security of supply issues. It also noted Ofgem had previously commented that a zero reserve price enables the market to clear, allows the market to determine the price of capacity and removes the price differential between entry points on the day – thus facilitating competition.

One respondent noted that the impact assessment did not consider the impact of vetoing the proposals and that the proposals should be considered as a first step, even though their impact may be limited. It argued that the proposals can only increase capacity and decrease commodity revenues which is important regardless of the scale.

Another argued that reserve price discounts under the status quo inhibit the secondary market and allow users at non-competitive entry points to acquire capacity and pass on costs to other users.

Two respondents consider that if reserve prices are not set on a cost reflective basis (due to discounts and interruptible being sold when firm remains available) then allowed revenue not collected via auctions will be collected via the commodity charge - implying that it is not cost reflective either. However, one noted that this improvement via removing the discounts would be modest.

One respondent noted that NGG data, presented to the review group, confirms that there is insufficient competition at the majority of beach entry points to avoid significant under-recovery. Another concludes that reserve price discounts have therefore done nothing to improve competition.

Another recognised that auctions will always result in a mismatch with allowed revenues which highlights the need for an adjustment mechanism. They thought the arrangements should be reconsidered as part of TPCR5.

A number of respondents were concerned that if the proposals were implemented access to interruptible would be restricted which could undermine the economic and efficient operation of NTS with a fall in liquidity and inconsistency with the EU third package.

One respondent agreed that there is no need to factor in the likelihood of interruption into the reserve price for interruptible capacity as this is reflected in the shipper auction bid. Another respondent was concerned about the Ofgem assessment against EU regulations which suggest that auction arrangements override other EU requirements particularly regarding cost reflectivity and avoiding cross subsidies.

One respondent considered that there was a contradiction in the IA that UNC285 has a negative impact on short-term liquidity in the gas market but that forward liquidity in the GB market is higher than in other gas and commodity markets. They also considered that UNC285 will improve competition in the non-UIOLI sector and that availability of interruptible capacity will not be an issue.

Another response noted that it had supported the proposals due to their stimulation of the secondary market but was disappointed that on balance Ofgem believes that there would only be modest impact and that this would be offset by reduced liquidity.

Question 2: Do you agree with our provisionally preferred approach which would be to not implement any proposal to reallocate the revenues from baselines?

Four respondents agreed that there should be no reallocation of revenues of within-day sales from the SO to the TO pot. They argued that this does not represent a proportionate solution to the perceived problem of volatile TO commodity charges and that more analysis is required.

Two respondents disagreed, with one of these commenting that the impact may be limited and suggesting a 'wait and see' approach.

Question 3: Are there any other factors we should consider?

The factors raised were that: SRMC is not mentioned in the relevant objectives and reference is only made to LRMC; the LRMC applies to monthly auctions which cannot trigger incremental capacity and so clarity sought on why monthly capacity should be set at a higher price than daily; and inconsistent for it to be acceptable for short-term users to pay above SRMC in the status quo (once commodity charges included) but not under proposals.

CHAPTER: Five

Question 1: Do you agree with our analysis of each of the options against the measures we consider?

Three agreed with Ofgem's analysis of the options whilst two disagreed. One of the latter disagreed as they considered NGG's analysis to be an overestimate and so believes Ofgem's analysis to be a similar overestimate. Another disagreed that GCM19 and UNC284 would result in more long term bookings arguing that shippers will wait to optimise portfolios before purchasing capacity for marginal or uncertain volumes of gas.

Question 2: Are there any other measures we should have assessed the options against?

The respondents did not identify any other measures that should have been assessed.

CHAPTER: Six

Question 1: Do you agree with our analysis on the impacts of the options on existing and future consumers being their interests as a whole in terms of both security of supply and reduction of greenhouse gases?

One respondent did not believe that high commodity charges is a specific reason why some LNG tankers are not coming to GB – they consider that the NBP gas price is the important factor.

Another thought that long term investment decisions are driven by wholesale gas prices which are significantly more volatile and unpredictable than the gas entry charging arrangements. Given that shippers are able to forecast and invest in these then the impact on investments and security of supply have been overstated.

One respondent that disagreed considered the proposals were a first step to creating a regime to minimise risk of avoiding delayed investment signals and disincentives for cross-border trade. They argued that the proposals should create more predictable long term charges which might reduce the probability of a high premium to cover uncertainty in the commodity charge being passed on to consumers.

One respondent conducted two pieces of analysis. The first analysis looked at (i) Basis Differential Curve i.e. 'NBP price less Zeebrugge gas price' (ii) the sum of actual SO and TO commodity charges in winter months (iii) sum of actual SO commodity charge plus the TO commodity charge which recovers 10% of TO entry revenue. It did this for 2008/9 and 2009/10. It assumes that gas will choose to flow to NBP instead of Zeebrugge where the Basis Differential Curve is above the sum of TO and SO commodity charges. The analysis concluded that due to the high TO commodity charge that gas would have flowed to the UK between 7 and 20 days in each year (and if TO commodity charge was set at 10% of the entry allowed revenue, this would be by extrapolation 12 and 60 days). This respondent did similar analysis for NBP against other markets with similar results.

The second piece of analysis assessed the correlation between Base Differential (between NBP and Zeebrugge) and the TO commodity charge. It found very little correlation. It concluded that any increase in NBP price from higher TO commodity charge is followed at other markets (i.e. they take the price lead from NBP) therefore the TO commodity charge does not result in a price differential between NBP and other markets such that those faced with the option of delivering gas to either would chose the NBP. It also concludes from this that if Basis Differentials are not affected by the TO commodity charge and there is limited ability to attract imports then we have to replace imports with UKCS (or storage in winter).

Question 2: Do you agree with our analysis on the impacts on health and safety?

Five respondents agreed with Ofgem's analysis on the impacts on health and safety.

Question 3: Do you agree with the risks and unintended consequences we have identified?

Two respondents agree with Ofgem's analysis whilst two others expressed agreements with specific aspects of Ofgem's views. One thought it unlikely that the proposals will lead to the withholding of capacity during high demand. Another agreed that an increase in secondary trading as a result of the proposals will not result in maximised revenues from their implementation.

One respondent disagreed with Ofgem's analysis arguing that the stimulation of secondary trading is not undesirable. It argued that the proposals should not be dismissed simply because the revenues are not maximised.

Question 4: Are there any other impacts we should have addressed?

The other impacts identified were that regulatory uncertainty, whilst it will always be there, should be minimised and that when the clearing allocation was introduced Ofgem considered there to be sufficient competition to avoid significant over-recovery – whilst NGG data suggests that there is limited competition.

CHAPTER: Seven

Question 1: Do you agree with our conclusions?

Six appear to support Ofgem conclusions noting that flat reserve prices removes cost reflectivity, removing discounts does not remove uncertainty in relation to pricing levels and UNC285 artificially restricts availability of capacity.

Six appear to disagree with Ofgem conclusions. One respondent was not convinced that there are low value users that would be disadvantaged from removing discounts as entry charges can be passed on at the NBP. It also considered that those booking short term capacity for storage are not contributing to system operating costs through the commodity charges. Another argued that Ofgem assumes perfect market conditions and economic principles can be applied but that this does not work with allowed revenues and spare capacity priced at zero. They continue that Ofgem acknowledges that competition in the short term for capacity is low but fails to indicate why keeping status quo of applying SRMC to daily capacity is better at promoting competition than when applying the LRMC to daily capacity.

Question 2: Are there any other issues that need to be raised to inform the Authority's decisions on these proposals?

The other issues raised include:

- that the proposals would increase regulatory uncertainty;
- high commodity charges hamper trade across interconnectors and hence across transmission systems – so not consistent with the Continent;
- EU regulations require tariffs to be set separately for every entry and exit point which is not the case for on-the-day entry reserve prices;
- UNC285 is more consistent with EU regulations as maintaining zero reserve price for interruptible but only releasing it when firm capacity is 90 per cent sold out means this is associated with a greater likelihood of interruption; and
- as commodity charges increase the optional-short haul charge becomes more attractive resulting in fewer users contributing to TO allowed revenues and a downward spiral in increasing TO commodity charges.

Other comments

A number of shippers offered alternative solutions including:

- NGG forecasts revenue collected from TO capacity sales in long-run and shippers use this to forecast commodity charge and build into their investment decisions;
- account for long term capacity bookings already made and apply location specific commodity charges, though this particular respondent considers this complex and costly process of allocating gas flows to different classes of capacity. Waive

capacity charges if they are less than the relevant location specific commodity charge at an entry point – turning entry charging arrangements into a form of take-or-pay;

- Analysis of appropriate price and spare capacity made available in short term is required in the future possibly including a review of baselines; and
- An 'annual entry ticket' for the right to participate in short term auctions where the price of an annual ticket reflects the maximum amount of short term capacity which a shipper wishes to be allowed to bid for. This would help bring in revenue and redress current inequitable charges whilst not distorting the SRMC signal.

One noted that the key objective must be to top up auction revenues in a manner which causes least distortion to the efficient use of the NTS.

A number of respondents raised concern over process, notably the time spent developing proposals, which Ofgem indicated its provisionally preferred approach to reject. One respondent requested that Ofgem acknowledges the significance of the issues and provide direction and timetable for further discussions.