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Dear Andrew,

NTS Exit Capacity Release Methodology Statement in respect of the Transitional and Enduring Periods

On 26 March 2010, National Grid Gas NTS ("NGG NTS") submitted to Ofgem¹ the National Transmission System (NTS) Exit Capacity Release (ExCR) methodology statement (the "Statement") in respect of the transitional and enduring periods. This was submitted pursuant to Special Condition C18 (the "Condition") of NGG NTS' gas transporter licence (the "Licence"). Having regard to the principal objective and statutory duties of the Authority², this letter sets out our reasons for not rejecting the statement.

Background

New NTS exit arrangements were first raised in the context of the Gas Distribution Network (GDN) sales process, which was completed in June 2005. At the time of GDN sales it was considered important by the Authority that the change in ownership of the gas transportation network did not create the potential for inefficient investment or inefficient operational decisions, particularly at the new commercial interface between the NTS and the GDNs. When the Authority gave its consent to GDN sales it required the introduction of a proposed enduring offtake framework.

In June 2005 the Authority decided to delay the introduction of enduring offtake arrangements to allow for further consultation in parallel with the Transmission Price Control Review (TPCR). As a consequence, transitional offtake arrangements were established for the 'Transitional period', or in other words the period preceding the introduction of enduring arrangements.

In January 2009 Ofgem directed implementation of UNC195AV which introduced reform of the booking arrangements for NTS exit capacity ("exit reform")³. These new exit arrangements are for the use of capacity from 1 October 2012 which means that there are two separate phases for release of NTS Exit Capacity, namely:

- the 'Transitional Exit Period' for capacity reserved or allocated to Users commencing no later than 30 September 2012; and

¹ Ofgem is the Office of the Gas and Electricity Markets Authority. The terms 'Ofgem', 'the Authority', and 'we' are used interchangeably in this document.

² Set out in Section 44A of the Gas Act 1986, as amended

³ UNC 195AV: Reform of the enduring NTS capacity arrangements 19 January 2009. A copy of this decision is available on the Joint Office of Gas Transporters website: www.gasgovernance.co.uk

- the 'Enduring Exit Period' in respect of capacity reserved or allocated commencing no earlier than 1 October 2012.

The ExCR methodology statement describes the process by which NGG NTS determines how it will release NTS exit capacity to gas shippers and GDNs. The first iteration of the statement following implementation of exit reform was submitted to the Authority in March 2009 to be applied with effect from 1 April 2009. The principal change to the statement concerned the introduction of a new section relating to the Enduring Exit Period. Among other things this section set out the processes for the release of "Enduring Annual NTS Exit (Flat) Capacity" through the Annual Application Window, through the ad-hoc process and via the Advanced Reservation of Capacity Agreements (ARCA) process. The section also set out the four year user commitment on capacity charges applying to the release of incremental Enduring NTS Exit (Flat) Capacity. In order to align the Transitional Exit Period with the Enduring Exit Period, it also confirmed that any new ARCAs signed in the transitional period would also require a User Commitment based on four years of capacity charges⁴.

On 18 February 2010 NGG NTS initiated its formal consultation on its proposed changes to the 2009 statement. The version of the methodology submitted to the Authority on 26 March has been revised to take account of the issues raised in the consultation (see the Consultation Conclusions Report⁵ which gives NGG NTS' view on all of the substantive issues raised by respondents as well as a track changed version of the statement). NGG NTS propose that the new statement be applied from 1 June 2010. In the section below we summarise the substantive changes proposed, and in the subsequent section we set out our views on the changes. The Annex to this letter sets out in detail our reasons for consenting to the exclusions to User Commitment proposed at Paragraphs 34(d) and 34(e).

Proposed changes to the ExCR methodology statement applying from 1 June 2010

Part A of the statement concerns the arrangements applying in the remainder of the Transitional Exit Period. Changes here include a new Paragraph 11 clarifying that additional capacity registered to Users during the Transitional Exit Period as a result of an ARCA, or in respect of new NTS Exit Points will, unless subject to a reduction request⁶, be registered to the same Users at the start of the Enduring Exit Period. Other changes in Part A concern the introduction at Table 1 of a footnote clarifying that where investment is required, it is unlikely that the lead-time for investment works (normally 38 months from the point of booking the capacity) will now allow the release of capacity ahead of the Enduring Exit Period. This statement is further qualified at Paragraph 35 in the section concerning 'Requests for Incremental Capacity beyond investment lead-times' with the caveat that 'there may be limited circumstances where capacity that requires investment can be released with sufficiently short lead-times that that capacity can be released in the Transitional Exit Period' but a new insertion at Paragraph 40 clarifies that before signature of an ARCA, NGG NTS would require a revenue driver in the Licence for the relevant NTS Exit Point.

Part B of the statement concerns the arrangements applying in the Enduring Exit Period. The majority of these changes provide additional clarity on aspects of the Enduring Exit arrangements such as the rules and User Commitment applying to Capacity Assignment or Transfer; capacity excluded from user commitment; and the procedure for allocating NTS exit (flexibility) capacity in the Enduring Exit Period.

⁴ ARCAs are agreements between NGG NTS and a counterparty whereby future capacity is reserved. In the previously approved methodology and the Transitional Exit Period, the ARCA was available to shipper users, GDN users and developers, and the User Commitment was based on one year of capacity charges. Any ARCA signed in the Transitional Period would provide capacity rights extending into the Enduring Period and so it was considered appropriate that the User Commitment should be aligned with that applying in the Enduring Period.

⁵ Review of the NTS Exit Capacity Release Methodology Statement in respect of the Transitional and Enduring Exit Periods. Consultation Conclusions Report. National Grid 26 March 2010.

⁶ Where, in relation to an NTS Exit Constraint, National Grid NTS would like to reduce the quantities of gas offtaken at an NTS Exit Point, it may invite offers from Users to reduce the offtake of gas in that location.

In respect of the rules applying to Capacity Assignment or Transfer, NGG NTS has drafted new paragraphs applying to the treatment of Enduring Annual NTS Exit (Flat) Capacity and Annual NTS Exit (Flat) Capacity. Paragraphs 59 and 118 have been drafted not to apply upon implementation of UNC276, while paragraphs 60 and 119 have been drafted only to apply upon its implementation.

UNC276 permits the partial assignment of capacity, aside from where it conflicts with any capacity trade or transfer in place or results in a reduced capacity amount being available to NGG for existing forward or option contracts. On 2 March 2010 the Authority directed implementation of the proposal⁷, but an implementation date has not yet been agreed. Paragraphs 60 and 119 will therefore take effect from the time of the implementation of UNC276. Both of these paragraphs state that assignment requests will be rejected regardless of the level of registered capacity if, as a result of current or pending capacity Transfers, or current or potential capacity surrenders pursuant to an exit capacity management agreement, a negative capacity entitlement occurs. New Paragraphs 58, 93 and 96 deal with the User Commitment applicable to Assignor and Assignee Users in respect of assigned capacity.

Other clarifications relating to User Commitment can be found at but are not limited to Paragraphs 34, 79 and 82. Paragraph 34(d) sets out the conditions under which a User Commitment will not apply to increases to initial allocations of Enduring Annual NTS Exit (flat) Capacity where there are corresponding decreases in the same application window at the same NTS Exit Point. Paragraph 34(e) specifies that a User Commitment will not apply to any increase in a User's registered capacity at any NTS Exit Point which is below the minimum eligible amount of less than 100,000 kWh/day. NGG NTS has sought the Authority's opinion on the exclusions to User Commitment contained in 34(d) and 34(e) in a correspondence separate to the ExCR consultation. The Annex to this letter provides more detail about the issues involved and sets out our reasons for consenting to the exclusions proposed.

New Paragraph 79 sets out, for the avoidance of doubt, one of the key principles of exit reform. The paragraph states that 'Consistent with the Licence, National Grid shall only release NTS obligated incremental exit flat capacity if a "long term signal" is received from a User or Reservation Party. The User Commitment, as defined in Paragraph 80 shall constitute the long term signal required under the Licence.' Paragraph 82 refers to the exclusions to User Commitment applying in certain circumstances by way of Assignment (referred to above) and in respect of matched increases and decreases to initialised allocations (referred to above), but deletes the text at what was previously 69(b) concerning User Commitment not applying in respect of allocations made 'in the July 2009 application window which do not require a revenue driver and are below or equivalent to the transitional firm capacity confirmed by National Grid before 1 May 2009 at that exit point'.

Changes at Paragraphs 85 to 90 clarify the User Commitment Amount payable. In particular Paragraph 85 specifies that where a User has an application to increase its registered capacity accepted and the User has or will have an existing User Commitment at the same NTS Exit Point at the time the increase becomes effective, the User Commitment will be determined using the most recently generated indicative price for an accepted capacity increase and commence on the latest User Commitment start date for all relevant increases individually. New Paragraph 90 provides the qualifier that where as a result of overlapping capacity increases a User Commitment is required to be recalculated, the most recently determined indicative price shall be used for the recalculation.

⁷ UNC276: Alternative User Pays approach to enabling the assignment of Partial Quantity of Registered NTS Exit (Flat) Capacity, 2 March 2010. A copy of this decision is available on the Joint Office of Gas Transporters website: www.gasgovernance.co.uk

The changes proposed in respect of NTS Exit (flexibility) capacity are intended to reflect the licence changes directed as a consequence of the implementation of UNC195AV. Special Condition C8E(4) no longer contains references to NTS flow flexibility in the obligation concerning the NTS exit capacity baseline statement. As such NGG NTS has proposed the removal of what was previously Paragraph 105 concerning the release of NTS Incremental Exit Flow Flexibility and the removal of the definition of NTS baseline exit flow flexibility from the section of Appendix B2 relating to "NTS Capacity Terminology Defined in the Licence".

Other changes to Part B include the amendment of an error in the definition of "Qres" at Paragraph 88, and the insertion within Appendix B2 of a new defined term Relevant Design Costs. Relevant Design Costs are referred to at Paragraph 57 and in the event that demonstration information in connection with an ad-hoc application for capacity is not received by the required date on three occurrences, Users will be liable to National Grid for such costs.

Ofgem's views

In reviewing this document the Authority considers that it complies with the requirements of Special Licence Condition C18, against which it was submitted, and therefore grants its approval to the methodology. Below, we give our views on the new proposal and the issues raised by respondents to the consultation exercise undertaken by NGG NTS.

With regard to the new Capacity Assignment and Transfer paragraphs at 60 and 119, we consider that these paragraphs properly reflect the intention of UNC 276 that from the time of that proposal's implementation NGG NTS is required to take account of any trade or transfer in place or pending before deciding on an assignment or partial assignment request. We also consider that it is appropriate that NGG NTS has restated the principle that in the Enduring Period a user commitment is required irrespective of whether or not the requested additional capacity can be met from existing system capability and/or is below baseline capacity as reflected in Paragraph 79.

In respect of the User Commitment Amount payable we note that in the enduring period Users signal their commitment to capacity based on the indicative charges signalled by NGG three years in advance of the capacity being delivered. Given the indicative nature of charges when users commit to capacity, we consider it is appropriate that users should not suffer excessive financial disadvantage through differences between actual and indicative charges that subsequently arise, but we note that it is correct that requests for additional capacity which require additional user commitment at a given exit point should be based on the latest indicative charges available.

Paragraph 69(b) of the 2009 ExCR Methodology Statement stated that a User Commitment would not apply in respect of capacity allocations made 'in the July 2009 application window which [did] not require a revenue driver and [were] below or equivalent to the transitional firm capacity confirmed by National Grid before 1 May 2009 at that exit point'. The initialisation of exit capacity holdings in advance of the 2009 application window was based on exit capacity baselines established at the time of the fourth Transmission Price Control Review (TPCR4). Due to the delay in implementing exit reform, it was identified that this initialisation approach would result in a number of new exit points being initialised at zero (i.e. capped at baseline) despite operating in the Transitional Exit Period. The reason for the 69(b) exclusion was that it was considered that it would be unreasonable for these exit points to have to reapply for capacity in the Enduring Exit Period with a consequent exposure to User Commitment. Following the 2009 application window we consider that this potential mismatch will have been resolved and we agree that it is now appropriate to delete the sub paragraph.

Among the parties who responded to NGG NTS' consultation one considered that the need to include new exit points in the Licence and to calculate revenue drivers was inappropriate and might increase the lead time for the release of capacity. We understand the preference

for NGG NTS to have new exit points included in the Licence as this facilitates efficient investment planning. We also recognise industry's concern that the mechanisms are timely and efficient. We are committed to playing our part to ensure the release of capacity within investment lead times. We plan to consult on a generic methodology for setting revenue drivers for the period until the end of the current price control i.e. to March 2012. This should speed up the process from requesting a revenue driver to one being included in the licence. We anticipate supplying the necessary revenue driver to achieve the default lead time of 38 months for incremental obligated exit capacity. Success in this objective, however, relies on applicants providing NGG NTS with advance notice and sufficient information to facilitate an early analysis of options.

Among the responses NGG NTS also received feedback on its proposed Relevant Design Costs term. One respondent queried whether it was appropriate to introduce such a term to the statement and expressed concern that the definition should be subject to consultation if it was to encompass the wider definition of "committed costs" as originally proposed. NGG NTS responded to this view by narrowing the definition of the term to exclude an overt reference to "committed costs" and to delete the expanded definition of procurement activities. In our view it is reasonable for NGG NTS to represent the term in the statement as a similar term is referred to in the UNC at Paragraph B3.3.7(b). However we agree with the respondent that any significant expansion of the definition of this term, either within the UNC or within the statement, should be subject to a wider industry consultation and we support NGG NTS' decision to narrow the definition at this stage.

NGG NTS also received feedback from one respondent on the proposed changes concerning the definition and representation of NTS Exit (Flex) Capacity in the Enduring Period. Among the respondent's concerns were issues relating to the consistency of terminology between the ExCR statement, the Licence and the UNC, and the purpose and transparency of terms such as Linepack Zones, NTS Exit Zones and NTS Exit Areas. In our view the changes NGG NTS have made to Chapter 5 are compatible with the recent changes in the Licence; however we do recognise the respondent's wider concerns about the transparency and consistency of information regarding flexibility capacity. In our view some of these wider concerns might be more appropriately addressed via another forum. NGG NTS held a number of industry workshops on Flexibility Capacity throughout 2009. Further, in the coming months it is our intention to publish an update consultation on the progress of developments in the flexibility capacity debate, but we note that the booking arrangements for NTS Exit (Flex) Capacity are defined in the UNC and as such are open to proposed modification by any UNC Party.

NGG NTS also sought industry views on the balance users would like to see between potential duplication of sections of the UNC and providing a comprehensive guide to the exit capacity regime. One shipper and one large gas customer representative considered that much of the statement, if not the entire statement, would be better incorporated within the UNC. The GDN respondent considered that it remained appropriate that the ExCR statement continued to provide a comprehensive summary of the exit regime. We understand that NGG NTS propose to further develop their thinking on this balance and will seek further industry views on the matter in advance of developing the statement for 2011.

Authority's decision

Following consideration of the documentation provided by NGG NTS pursuant to Special Licence Condition C18 and having regard to the Authority's principal objective and statutory duties the Authority approves the NTS Exit Capacity Release Methodology Statement.

Yours sincerely

Stuart Cook

Senior Partner, Transmission and Governance

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

Annex

NGG NTS has sought the Authority's opinion on the exclusions to User Commitment proposed in Paragraphs 34(d) and 34(e) of the ExCR methodology statement in a correspondence separate to the ExCR consultation. This annex provides more detail and sets out our reasons for consenting to the exclusions proposed.

Background

Following the decision to introduce enduring exit reform in January 2009, NGG reviewed and revised its ExCR methodology statement. Following the July 2009 annual application window it became apparent that the revised ExCR methodology statement did not address two scenarios where the rules gave rise to unintended consequences. These were:

Scenario 1

The first scenario relates to circumstances where two shippers change their capacity requirements at the same exit point but in a way that the aggregate requirement remains unchanged. For example, the following situation might arise:

- (i) Before the July 2009 application window:
 - Shipper A had initialised holdings of 10 units of capacity at exit point 1.
 - Shipper B had initialised holdings of 10 units of capacity at exit point 1.
 - Therefore total capacity held at exit point 1 is 20 units.
- (ii) In the July 2009 Application Window:
 - Shipper A reduces holdings to 0
 - Therefore, Shipper A would hold 0 units of capacity at exit point 1
 - Shipper B requests increase of 10 units
 - Therefore, Shipper B would hold 20 units at exit point 1
 - So total capacity held at exit point 1 remained at 20 units.

Scenario 2

The second scenario relates to circumstances where requests for capacity were below the minimum threshold, which were only possible due to the circumstances of the exit baselines being re-set in June 2009⁸. For example, the following situation might arise:

Distribution Network (DN) baseline (pre baseline re-setting in Jun 2009)	= 100,000,000 kWh
Capacity that DN was initialised as holding prior to July application window	= 100,000,000 kWh
DN baseline (post re-setting of baselines in June 2009)	= 110,000,000 kWh
Capacity that DN applies for in July 2009 Application Window	= 110,001,234 kWh

Therefore the DN applies for 1,234 kWh above the post baseline re-setting figures. This is below the minimum application threshold of 100,000 kWh/day and would not have been possible had the baselines not been reset.

Under the prevailing ExCR methodology statement these two scenarios would have resulted in a user commitment being required, which for the reasons given in the 'Ofgem's view' section, we do not think would have been appropriate.

Proposal

NGG asked Ofgem whether user commitment should be applied in these two scenarios. We agreed with NGG that it did not seem appropriate that user commitment should be applied in these scenarios (for reasons cited below), however, we considered it appropriate that industry be consulted on this. We therefore recommended that NGG consult on two further exemptions from user commitment in its annual review of the ExCR methodology statement in 2010 to cover these scenarios.

NGG included in its 2010 consultation on revising the ExCR two further exemptions to user commitment. These were set out in sub-paragraphs 34(d) and 34(e) in the section relating to exit capacity in the enduring period.

The specific additional exclusions were worded as follows:

⁸ In June 2009 a number of DN baselines were re-set to avoid potentially large amounts of incremental capacity being triggered at the first annual allocation window. The aggregate baselines in a DN area remained constant.

(d) increases to initial allocations of **Enduring Annual NTS Exit (Flat) Capacity** where there are corresponding decreases, in the same application window, at the same NTS exit point, provided that:

- Each increase and decrease has an effective date of 1st October 2012;
- There is no increase in the aggregate capacity allocation for all Users; and
- The increases and decreases are adjustments to the Users' initialised allocations

This rule (paragraph 34(d)) shall cease to apply on 1st June 2011 prior to the introduction of assignment processes.

(e) any increase in a User's registered capacity holding at any NTS Exit Point, notwithstanding the minimum eligible amount (UNC TPB Section B3), of less than 100,000 kWh/day

As Ofgem has until 26 May 2010 to make its decision on the revisions to the ExCR methodology statement, NGG wanted to be in a position to inform users of their user commitments with as much advance notice prior to the invitation to the July 2010 annual application window (to be issued in June 2010). Therefore NGG sought comfort from Ofgem on this issue ahead of the ExCR methodology statement decision.

Ofgem's view

UNC276 will allow for users ('**assignor**' users) to assign partial holdings of, *inter alia*, Enduring Annual exit capacity to other users ('**assignee**' users) at the same exit point. The implications of user commitments for both parties following an assignment process are such that where assigned Enduring Annual exit capacity has no user commitment associated with it and the assignee's existing Enduring Annual exit capacity also has no user commitment attached to it then the final amount of Enduring Annual exit capacity, following the assignment, that is held by the assignee will have no user commitment associated with it.

The ExCR methodology statement, following the 2009 review, states that no user commitment will apply as a result of allocations resulting from initialisation (which are effective from the start of the enduring period). Therefore, as the exemption from user commitment proposed in sub-paragraph 34(d) relates to increases in initial allocations then both the users requesting an increase and a decrease will have no user commitment associated with their holdings of Enduring Annual exit capacity. The proposed exemption from user commitment in sub-paragraph 34(d) is therefore in harmony with the requirements of partial reassignment, to be implemented as a result of UNC276. Ofgem considers that to require user commitment in scenario 1, described above, would be discriminatory. If these users had acquired Enduring Annual exit capacity through the assignment process, they would have avoided incurring any user commitment.

With regards to scenario 2 above, if the post baseline re-setting figures had been used in the initialisation process (this process provides users with initial allocations of Enduring Annual exit capacity prior to the enduring period), instead of the pre baseline re-setting figures, then shippers would not have been able to request Enduring Annual exit capacity increases of amounts less than 100,000 kWh/day above the post baseline re-setting figures. This is due to the fact that the minimum amount of capacity that can be requested is 100,000 kWh/day. Therefore, it does not seem appropriate to apply user commitment to small increases above the post baseline re-setting values which would not have been possible had the post baseline re-setting figures been used in the initialisation process.

The scenarios described were not foreseen in advance of the annual review of the ExCR Methodology Statement in 2009. We consider it appropriate to take steps to remedy these unforeseen discrepancies and therefore agree in principle to the two additional exclusions to user commitment as suggested in sub-paragraphs 34(d) and 34(e) of the ExCR methodology statement.