GCD04 Entry Capacity Discounts – Consultation Summary

Gas TCMF

5th July 2007

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Background

- Obligated NTS Entry capacity available in long term and short term entry auctions
  - 10% held back for short term
  - reserve price discounts for daily firm
- Zero reserve price (100% discount) on the day consistent with National Grid NTS Licence obligation to hold a clearing auction
- Interruptible capacity available
  - UNC defined UIOLI basis (Previous 30 day unused firm)
  - 100% reserve price discount
- Are the Entry Capacity Discounts still appropriate?

NTS Entry Capacity Discount Pros & Cons

Pros…………….

- Zero reserve price (100% discount) on the day consistent with National grid NTS Licence obligation to hold a clearing auction
- No pricing disincentive for all available capacity to be cleared
- Removal of price differentials between terminals facilitates competition between terminals
- Reduced reserve price may be consistent with User risk associated with on the day entry capacity procurement

Cons…………….

- Cost reflectivity diluted by under-recovery adjustment
  - New entrants (new ASEPs with zero baseline) may cross subsidise existing Users
- User disincentive to commit in long term auctions
- Weakened pricing and investment signals from long term auctions
- Incremental investment may not be triggered
  - risk of constraints
  - high/volatile short terms prices
- No trading opportunity at unconstrained ASEPs – what is true firm requirement on the Day?
- Interruptible price may not reflect likelihood of interruption if firm remains unsold on the day

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Discussion Paper

- NTS Gas Charging Methodology Discussion Paper NTS GCM 04: “Revisions to NTS Capacity Reserve Price Discounts”
  - Issued 11th May 2007
  - Closed out 21st June 2007.

Questions for Discussion

1. Principle that in the absence of competition discounts should not apply?
2. Principle that in the absence of material likelihood of interruption, interruptible discounts should not apply?
3. Impact on Secondary trading?
4. Requirement for clearance of obligated capacity?
5. Should day ahead discounts be removed, removed conditionally or retained?
6. Should within day discounts be removed, removed conditionally or retained?
7. Should interruptible discounts be removed conditionally or retained?
8. Impact on TO Commodity?
9. Timing of future proposals?

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Subsequent Changes

- GCM01 Implemented
  - Transportation Model based prices should recover greater proportion of TO allowed revenue
- Reduction of Baselines
  - Incentive to procure in long/medium term auctions
- Transfer/Trading/Substitution
  - Increased risk associated with leaving capacity procurement until day-ahead.
- Outcome of AMSEC auction
  - TO Commodity charge to be reset to minimal/zero level from 1st October 2007 as a consequence of revenue implied by the AMSEC auction

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Industry Views

Respondent	Abbr.	View
Total E&P UK Plc	TOTAL	REMOVE: Support conditional removal of discounts
EDF Energy	EDF	REMOVE: Support removal of discounts
Statoil UK	STUK	COMMENTS: believes that it may be better to consider this issue once the effects of the current changes to the entry capacity regime can be demonstrated.
RWE npower	RWE	RETAIN: Support retaining discounts
E.On UK plc	EON	RETAIN: Support retaining discounts

Summary

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Support for Retaining Discounts

- RWE
  - “still believe that the availability of firm and interruptible entry capacity close to the gas day is an important feature of the current regime. It allows shippers to manage their position and react to changing circumstances.”
  - “ the wider changes proposed to the regime will go a considerable way to addressing many of the concerns highlighted in the discussion document. Clearly, if there continues to be significant under-recovery then the matter should be reconsidered but the regime changes should be allowed to bed-in first.”
- EON
  - “do not agree that discounted reserve prices are encouraging shippers to avoid procuring entry capacity in the long-term auctions. It is our view shippers are likely to be purchasing capacity on the day or day-ahead not because they are deliberately trying to pick up capacity at zero or near-zero cost, but because of the need to manage daily volume risk. As such, the availability of capacity in the short-term is a very important portfolio tool and increasing the current costs of procurement could lead to larger risk premiums being passed through to consumers.”
  - “For the benefit of better competition in the gas wholesale market it is also important not to reduce the amount of, or access to, short term capacity: Primarily for the benefit of potential new entrants. If all capacity is tied up in long-term contracts, it could be argued that this leads to foreclosure of the wholesale market.”

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Support for Removing Discounts

- Total E&P
  - " T.O under-recovery due to weak participation in the longer term auctions."
  - "shippers at certain entry points buy substantial amounts of capacity on the day-ahead and within day auctions, forcing NG to apply ever increasing TO Commodity Charges to compensate for the under-recovery, with the added problem that this charge is smeared across all shippers leading to cross-subsidies and the dilution of cost-reflectivity."
  - " shipper's costs should be mainly due to Entry Capacity charges and only exceptionally due to the T.O commodity charge."
  - " in the absence of effective competition NTS entry capacity reserve prices should not be discounted for Daily Auctions of Firm Capacity."
  - "Option 2 limits the risk of NG facing TO under-recovery whilst at the same time it provides the flexibility in the system to accommodate for new shippers and attract flows that may have not been planned long term, such as storage or continental flows in the event of a Gas Deficit Emergency."
- EDF
  - "believes that the core benefits that these proposals should deliver are to encourage Users to book long term capacity, and encourage the development of a secondary market for trading capacity."

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DISEC Pricing

- UNC 2.5.10 defines interruptible capacity as: “an amount of NTS Entry Capacity equal to the daily average unutilised firm capacity.”
- **EDF**
  - “there has been no cost to NGG associated with the release of this capacity, as this should have been recovered from the firm capacity holders, instead it releases unused capacity. As no costs are associated with the release of the unused capacity, it would therefore appear that no charges should be associated with it.”
- **Total E&P**
  - “believe that in the absence of material likelihood of interruption, NTS interruptible capacity should not be auctioned at zero reserve price.”
  - “if Interruptible capacity is only offered at a zero reserve price when 90% of the firm capacity available is sold, this means that those buying interruptible capacity are in effect buying a product which can be interrupted, avoiding the case where as not enough firm capacity has been sold, the interruptible product is in practice not likely to be interrupted.”

Are Users really buying interruptible capacity when firm remains unsold, which might be the case if firm discounts were removed?

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Transportation Model

- RWE
  - “The replacement of Transcost by a Transportation Model is expected to produce more stable and cost-reflective reserve prices. With more capacity bought long-term at more reflective prices, it is reasonable to conclude that the growing under-recovery against allowed revenue might not persist.”
- EON
  - “Given the introduction of the Transportation Model in October 2007, a pre-winter trade and transfer process to be implemented, new entry substitution arrangements and probable reform of entry interruption arrangements, there is a danger of over-burdening the industry with vast and significant change in a short period of time.
  - All of the above may also result in changes in behaviour and/or potentially mitigate some of the problems NG appears to be currently concerned about.

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QSEC discounts

- EDF
  - "We would note that in the majority of markets and contracts, a discount is applied for entering into a contract with a longer lead time than entering into one with a shorter lead time, as this provides the seller with certainty regarding income and demand, whilst providing an incentive on buyers to enter into such a long term contract.
  - Whilst we recognise that NGG's licence conditions and price controls prevent NGG from offering a discount for long term capacity we believe that a methodology could be implemented that replicates this common business practice.
  - It would appear that rather than offering a discount to long term capacity, NGG could apply a premium to shorter term capacity. This would encourage Users to book longer term capacity and by placing a value on day ahead and within day capacity this would encourage the development of a secondary market."

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Impact on other Charges

- EDF
  - Removal of discounts "may expose NGG to over recover revenues during a price control period, however we believe that this could be overcome by either scaling down all reserve prices to reflect this, or the current smear back mechanism could be employed using any over recovery to fund buy back costs, or as a negative TO Commodity charge."
- RWE
  - "As the TO commodity charge is designed to correct for auction under-recovery then there will be an effect to the extent that there is an under-recovery. We believe that the arrangements introduced under the current price control, reduced baselines and use of a Transportation Model will reduce the extent of under-recovery and may create over-recovery."

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Impact on Secondary Trading

- EON
  - "would question whether there is really any need to encourage secondary trading at an ASEP when there is a surplus of primary capacity."
  - "this issue only becomes relevant when there is a constraint – i.e. for transfers of capacity to sold-out ASEPs. This is when it is potentially desirable to encourage secondary trading."
- RWE
  - "There are other factors that influence the lack of secondary capacity trading, for example that entry capacity has, to date, been a low value product, costs are largely sunk costs and it provides an element of insurance against overruns. "

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Future Consultations

- EON
  - “ would strongly advocate delaying any possible reform until at least October 2008. Indeed, the need for change may differ substantially in a year’s time in light of the overhaul of entry arrangements, so we would encourage pragmatism and caution in any approach to reviewing reserve price arrangements.”
- RWE
  - “The current discounts should remain in place and the issue reconsidered following the next long and medium term auctions and once the transfer and trade mechanisms have been established.”

Summary

- Consider
  - Revised baselines, Substitution, Transfers & Trades might incentivise greater participation in QSEC/AMSEC auctions hence minimising impact of DSEC discounts
  - AMSEC implied revenue will minimise TO Commodity Charges
- Propose
  - Extend GCD04 close-out
  - Consider changes for October 2008