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Dear Jan

Discussion Document NTS GCD01:
Introduction of NTS Exit (flat) Capacity Charges under the Enduring Offtake Arrangements

Thank you for providing Scotia Gas Networks (SGN) with the opportunity to comment on the questions raised in the above Discussion Document.

SGN supports the replacement of the existing Transcost model with a Transportation model of the NTS to calculate LRMCs. The Transportation model appears to have some methodological and some practical advantages compared with Transcost. These are dealt with under the questions below.

Q2. LRMCs are calculated from a Transportation model of the NTS, consequentially excluding spare capacity and including a backhaul benefit equal to the avoided cost of reinforcement.
The treatment of spare capacity and backhaul in the Transportation model seems to be more appropriate to the current circumstances of the NTS with some of the older terminals declining and alternative sources of supply becoming more important. The detailed modelling of the system required by Transcost, which includes spare capacity and excludes backhaul is both more difficult to carry out and less appropriate for the foreseeable future. Backhaul is likely to become more of a feature of the NTS in the future, and therefore it seems appropriate to include it in the model. Good arguments can be made for including or excluding spare capacity but on balance SGN agree with the case put forward by NG NTS that it will be more cost reflective and result in fairer charges to Users (including DNs) if spare capacity is excluded.

Q3. NTS Exit (Flat) Capacity prices are determined separately for each gas year from analysis of a single year Supply and Demand forecast using the relevant Gas Year's base case data and network model for the capacity released.
The determination of capacity charges using a one-year model will have advantages in reducing the reliance that Transcost has on ten-year forecasts. By not forecasting so far ahead the Supply/Demand forecast and the network model should be more accurate and therefore the results should be more cost-reflective. The removal of the ten year averaging will allow NGNTS to provide more specific temporal and locational pricing signals which should enable Users to make more informed investment decisions. It will also remove the circularity in Transcost where LRMCs are based on future network and supply/demand data which are themselves forecasts of entry auction outturns.

One potential disadvantage of the single year forecasting from a DN point of view is that charges for Prevailing Exit (Flat) Capacity will be set for the forthcoming gas year based on the supply/demand forecast and network model for that year. It therefore appears that DNs will have to apply for Prevailing Exit (Flat) Capacity in July of gas year Y for gas years Y+4 onwards without knowing what the charges for that capacity will be in those years. With the proposal to remove the capping on year-to-year changes in the charges this could apparently mean significant changes in the level of the charges at some exit points between DNs committing to the capacity and actually having to pay the charges.

In this respect NTS GCD01 is not consistent with the Exit Capacity Release Methodology Statement (Issue 1) which contains two options for Prevailing Exit (Flat) Capacity charges. Option 1 is similar to GCD01, but Option 2, entitled "Commitment Based on Price at Time of Application" states that the Prevailing Exit (Flat) Capacity charge would be the relevant prevailing Exit Capacity price at the time of application. SGN support this option and believe it is the one which should be implemented in the new Exit Capacity charging methodology. Under the new regime DNs will be required to make economic decisions between booking additional NTS Exit Capacity and investing in their own networks. In order to make rational and defensible decisions they therefore need to know what they will have to pay for additional Exit Capacity at the time of commitment.

Q4. Entry and Exit LRMCs be calculated from the cost from a "reference node" to each relevant offtake point and the cost from each entry point to the "reference node" and that the LRMCs is adjusted to give a 50:50 split between average positive value of these adjusted Entry and Exit costs.

SGN support the calculation of LRMCs using the less complex methodology of the Transportation model compared to Transcost. SGN also agree that the LRMCs be adjusted to give a 50:50 split between average positive value of these adjusted Entry and Exit costs

Q5. LRMCs are calculated from Transcost, consequentially including spare capacity and excluding any backhaul benefit.
SGN do not support the continued use of Transcost to determine LRMCs for two main reasons.
1. The inclusion of spare transmission capacity and the omission of backhaul benefit produce the counter intuitive allocation of costs to northern exit points and southern entry points that is shown in the TCMF Analysis Report (Oct 2006).
2. Transcost has always been a relatively complex model to use, and is becoming more so because the less stable flow patterns expected in the near future make the choice of network configuration and compressor and regulator parameters more difficult and more time consuming and with a larger element of subjectivity. Using the model effectively would require a very good knowledge and understanding of the NTS. On the basis that NG NTS intend to make their LRMC model available to Users and DNs to enable them to replicate NG's analyses and carry out their own sensitivity analyses it would be far more useful if the model provided is the Transportation model rather than Transcost.

Q6. NTS Exit (Flat) Capacity Prices and auction reserve prices for all relevant gas years are determined from a single weighted average analysis of the ten year supply and Demand forecast using the current Gas Year's base model.
SGN does not support the continued use of the single weighted average of the ten years Supply/Demand and Network analysis as used in Transcost. SGN's view of the advantages of moving to a single year model are described under Q3 above.

Q7. Entry and Exit LRMCs be calculated from route costs associated with an incremental flow of 2.834mscm for every combination of entry and exit point and that the route LRMCs are disaggregated into entry and exit LRMCs using an excel based solver constrained to give a 50:50 split between average positive values of these adjusted Entry and Exit costs.
SGN does not support the continued use of the Transcost based methodology as described above to calculate LRMCs. SGN support the calculation of LRMCs using the less complex methodology of the Transportation model compared to Transcost. SGN do agree that the LRMCs should be adjusted to give a 50:50 split between average positive value of these adjusted Entry and Exit costs.

Q8. Prices are set at a nodal level rather than an exit zone level for all NTS exit points.
SGN has no objections to the proposal

Q9. Exit LRMCs are converted into prices using the annuitisation factor set out in NG's NTS Transportation Licence.
SGN has no objections to the proposal

Q10. No year on-year capping of NTS Exit Capacity prices is included in the methodology.
SGN does not support this proposal on the grounds that it could allow an unacceptable degree of variability and unpredictability in the NTS Exit Capacity prices. Under the new regime DNs will be required to make economic decisions between booking additional NTS Exit Capacity and investing in their own networks. It will be extremely difficult for the DNs to make rational decisions in a regime where one element of these decisions, the Exit Capacity charges, may be subject to large year-on-year changes.

Given that NTS Exit Capacity charges have not been rebalanced to reflect changes in the supply/demand balance and network configuration since 2001 the changes at some exit points could well be quite substantial. SGN believes it would be quite unreasonable to impose large changes on the industry in a single year, and that large changes should be phased over a number of years. The impact of phasing on cost-reflectivity would be temporary and it is difficult to see why NG NTS would consider this a serious problem given their lack of action in this area since 2001. SGN therefore believes that the option of capping changes in the charges should be re-considered and it should be included in any subsequent pricing consultation paper.

Q11. Interruptible NTS Exit (Flat) Capacity Prices are discounted by 100%
SGN Supports this proposal

Other Issues
Recovery of Allowed Revenue
It is proposed in the Discussion Paper (para 3.15) that no adjustments be made to the Exit (Flat) Capacity prices to recover a fixed percentage of allowed revenue. At the Gas TCMF on 16 November it was stated that without adjustment the Exit (Flat) Capacity prices would be expected to recover only 45% of the target NTS Exit Capacity revenue. The balance of the revenue would be collected through a TO Commodity Charge. SGN believes that it is unrealistic for NGNTS to plan to recover such a low percentage of target allowed revenue from the Exit (Flat) Capacity Charges. The reason for not adjusting the charges is not given in the paper, but in NTS GCD 03 it is said that in discussion at the Gas TCMF it was apparently recognised that revenue recovery through adjusted Exit Capacity charges is more consistent with an administered pricing regime whereas commodity charges are more consistent with a regime including auctions. The concern is apparently that adjusted exit capacity charges might distort auction behaviour and capacity price locational incentives.

However because the bulk of the Exit (Flat) capacity will be sold as "Prevailing" for which charges will be set by NG NTS the regime will still be largely one with administered prices and therefore adjusted capacity charges would still be appropriate.

Under the current proposals if 55% of the Exit Capacity allowed revenue is to be collected through a flat TO commodity charge which is completely un-cost-reflective then the total balance of the charges will be far less cost reflective than if the "raw" Exit Capacity Charges were adjusted to recover the total target allowed revenue.

Recovering such a high proportion of the Exit Capacity revenue through a commodity charge would create additional problems for the DNs because the revenue to be paid through commodity charges is far less predictable than the revenue to be paid through capacity charges. This is particularly the case as the DNs are currently in the process of reducing the proportion of commodity-based charges in their charging structures.

It is not clear why the Exit (Flat) Capacity charges should not be adjusted under the enduring offtake arrangements when in the Consultation Document NTS GCM 01 "Alternative Methodologies for Determination of NTS Entry and Exit Capacity Prices" which covers the transition period up to 30 September 2010 it is proposed that the charges be adjusted to recover the target TO allowed revenue (para 4.18). This paragraph proposes that the charges be adjusted additively, rather than proportionately, as at present, as an additive adjustment would preserve the locational differentials between the "raw" NTS Exit Capacity charges. It appears that the same logic is not applied in NTS GCD 01 because adjusted charges might distort auction behaviour. However as the bulk of Exit Capacity will be "Prevailing" to which administered charges will apply the difference in treatment does not seem valid.

We hope these comments are helpful.

Should you require any further clarification or wish to discuss any point in more detail, please contact me at the above address.

Yours sincerely

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