

DISCUSSION REPORT

**Modification Proposals to the Gas Transmission
Transportation Charging Methodology**

NTS GCD 04R:

**Revisions to NTS Entry Capacity Reserve Price
Discounts**

10th January 2008

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Executive Summary

Gas Charging Discussion Document NTS GCD04 set out for discussion options for revising the Gas Transmission Transportation Charging Methodology (the “Charging Methodology”) in respect of the setting of Firm and Interruptible NTS Entry Capacity discounts. The document was produced by National Grid in its’ role as Gas Transporter Licence holder in respect of the NTS (“National Grid”). This report summarises the responses

National Grid currently sets Obligated NTS Entry Capacity reserve prices for all long, medium and short term Entry Capacity auctions on the same basis but applies discounts for Day-ahead and within-Day auctions. Revenue collected from all auctions held ahead of the Day is treated as TO entry revenue and any shortfall of allowed Transportation System Owner (TO) entry revenue is recovered through a uniform TO Entry Commodity Charge applied to flows at non-storage Entry Points. Net revenues and costs for within-Day capacity are shared between Users via the capacity neutrality process, with Users receiving or paying prorated to their firm capacity holdings.

Zero reserve prices were introduced for within-Day firm capacity auctions in 2003 and at the time it was considered that there may be sufficient competition at the majority of large beach terminals to guard against revenue under-recovery. There was also an expectation that the majority of shippers’ Entry Capacity requirements would be procured well in advance of the gas day. It was also considered that non-zero reserve prices might inhibit price discovery. The bulk of within-Day capacity sold has been close to the reserve price, thus there is little evidence of true price discovery. This may also be a factor that inhibits shipper to shipper capacity trading at ASEPs. As a consequence Entry revenue under-recovery has increased year on year to the extent that the TO Entry Commodity Charge now exceeds reserve prices at most terminals.

National Grid is concerned that the prevailing use of discounted reserve prices in short term auctions has generated effects that might be considered undesirable.

- There may be a disincentive to book capacity in the longer term, undermining locational signals for Entry Capacity in all auctions and undermining long-term signals for incremental capacity.
- Zero/discounted reserve prices may have led indirectly to the high and unpredictable short term capacity prices experienced when capacity becomes scarce.
- New entry points may be at a disadvantage in that no short term discounted capacity is available.
- Prices paid for interruptible capacity do not reflect the likelihood of interruption and therefore such Users receive a benefit from other Users paying for firm capacity.
- Discounted reserve prices for all short term auctions may have led to higher TO Entry Commodity Charges arising from under-recovery of allowed revenue.

NTS GCD04 sought views on the principles involved and on the following options:

- Day-ahead NTS firm Entry Capacity auctions – should the 33% discount on Obligated NTS Entry Capacity Reserve Prices be retained, removed or applied conditionally at each NTS Entry Point?
- Within-Day NTS firm Entry Capacity auctions – should the 100% discount on Obligated NTS Entry Capacity Reserve Prices be retained, removed or applied conditionally at each NTS entry point?
- Interruptible NTS Entry Capacity auctions – should the 100% discount on NTS Entry Capacity Reserve Prices be retained, or applied conditionally at each NTS entry point?

Summary of Responses

National Grid NTS received 5 responses to its consultation on NTS GCD 04; two were in support of removing firm entry reserve price discounts, one offered comments and two were not in support. None of the responses were marked as confidential, and copies of the responses have been posted on the Gas Charging section of the National Grid information website.

Conclusions

The discussion paper was raised at a time when Users had expressed concerns about the increasing charge rate of the TO Entry Commodity charge. National Grid had raised a concern that the Entry Capacity discounts were contributing towards the high TO Entry Commodity rate through both the impact on daily revenue and through the disincentive to participate in the long term auctions. The outcome of the 2007 AMSEC auction has, however, led to the TO Entry Commodity charge rate being set to zero. This resulted from competition for Entry Capacity pushing up clearing prices, due to changes to baseline levels, demand for Entry Capacity exceeding availability at some ASEPS and the transferability of Entry Capacity resulting from the Trade & Transfer process. National Grid is concerned, however, that high TO Entry Commodity charges may return once east coast NTS reinforcements have been completed.

Way Forward

National Grid will continue to keep the Charging Methodology under review in compliance with its transportation Licence in respect of the NTS and in light of any further changes to baseline NTS Entry Capacity and capacity access processes. National Grid accepts that changes to discounts need to be considered in light of any further changes to the Baseline Entry Capacity levels and enduring Trade & Transfer processes and hence intends to further investigate the issues via the Gas TCMF in 2008.

1 Introduction

- 1.1 Gas Charging Discussion document NTS GCD04 set out for discussion options for revising the Gas Transmission Transportation Charging Methodology (the “Charging Methodology”) in respect of the setting of Firm and Interruptible NTS Entry Capacity discounts.
- 1.2 National Grid in its’ role as Gas Transporter Licence holder in respect of the NTS (“National Grid”) currently sets Obligated NTS Entry Capacity reserve prices for all long, medium and short term Entry Capacity auctions on the same basis but applies discounts for Day-ahead and within-Day auctions. Revenue collected from all auctions held ahead of the Day is treated as TO entry revenue and any shortfall of allowed TO entry revenue is recovered through a uniform TO Entry Commodity Charge applied to flows at non-storage Entry Points. Net revenues and costs for within-Day capacity are shared between Users and National Grid SO via the capacity neutrality process, with Users receiving or paying prorated to their firm capacity holdings.
- 1.3 Since October 2003 a discount to reserve prices for within-Day Entry Capacity auctions has been set at 100%, i.e. a zero floor price. This applies to both Firm and Interruptible Capacity. Day-ahead capacity has been offered at 33% of the NTS Entry Capacity reserve prices.
- 1.4 At the time it was considered that there may be sufficient competition at the majority of large beach terminals to guard against revenue under-recovery. There was also an expectation that the majority of shippers’ Entry Capacity requirements would be procured well in advance of the gas day. It was also considered that non-zero reserve prices might inhibit price discovery. The bulk of within-Day capacity sold has been close to the reserve price, thus there is little evidence of true price discovery. This may also be a factor that inhibits shipper to shipper capacity trading at ASEPs. As a consequence Entry revenue under-recovery has increased year on year to the extent that the TO Entry Commodity Charge now exceeds reserve prices at most terminals.

2 Background

Entry Capacity Baselines and Reserve Prices

- 2.1 National Grid offers NTS Entry Capacity for sale in a series of long, medium and short term auctions. It was envisaged that Entry Capacity auctions would provide reliable and robust investment signals and avoid undue preference in the provision of Entry Capacity. Currently, National Grid has a Licence obligation to make available capacity up to the defined Obligated NTS Entry Capacity level at each ASEP in a clearing allocation by the end of the Gas Day.
- 2.2 For the avoidance of doubt, the obligated Entry Capacity level incorporates:
 - Initial NTS SO Baseline Entry Capacity as defined by the Licence
 - Incremental obligated capacity that has previously been released
- 2.3 In the future, the obligated Entry Capacity level will also incorporate Entry Capacity that has been substituted to or from the ASEP as a result of National Grid’s Entry Capacity Substitution Methodology.

- 2.4 A proportion of NTS SO Baseline Entry Capacity (10% for the 2007-2012 Price Control Period) is held back from earlier auctions for full release in monthly and shorter term auctions (<18 months ahead). In the case of new entry points the initial NTS SO Baseline Entry Capacity is zero and therefore there are no medium or short term auctions.
- 2.5 A clearing allocation was defined in the National Grid Licence¹ as:
“in respect of a terminal and period an allocation of Entry Capacity which either:
- results in all the capacity offered for sale being sold; or
- has a reserve price of zero;”
- This however should not “contravene the provisions of..” Charging Licence obligations. The latter includes the requirements to ensure that reserve prices are set in a way that promotes competition, promotes efficient use of the system and avoids undue preference in the provision of transportation services.
- 2.6 National Grid currently sets Obligated NTS Entry Capacity reserve prices for all long, medium and short term Entry Capacity auctions on the same basis but applies a discount for Users that purchase capacity in the short term auctions – 33.3 % for Day-ahead, and 100% for within-Day firm and interruptible capacity.
- 2.7 Ofgem’s 2007-2012 Price Control included a reduction in some NTS SO Baseline Entry Capacity levels and Proposals for introduction of an obligation on National Grid to provide mechanism(s) to if necessary move Obligated NTS Entry capacity between ASEPs (as outlined in more detail in section 3).
- 2.8 In 2003, when zero reserve prices were introduced² for within-Day firm capacity auctions, it was considered that there may be sufficient competition at the majority of large beach terminals to guard against revenue under-recovery. There was also an expectation that the majority of shippers’ Entry Capacity requirements would be procured well in advance of the gas day. Additionally it was considered that non-zero reserve prices might inhibit the release of NTS Entry Capacity and inhibit price discovery.
- 2.9 The 100% discount for interruptible prices (i.e. a zero price) increases the likelihood of additional capacity being released, where available, in the short term, and recognises the right of the system operator to curtail interruptible Entry Capacity on the Gas Day.
- 2.10 It should be noted that NTS Interruptible Entry Capacity is made available where there is an expectation (as defined in the UNC³) that there may be unutilised firm NTS Entry Capacity on a gas day and at the discretion of National Grid as SO.

¹ NTS Gas Transporter Licence Special Conditions C8A and C8B, April 2007

² Transco Pricing Consultation 76 and Transco Modification Proposal 0630

³ Uniform Network Code v2.33 Transportation Principal Document B2.5.10/11

Under-recovery of Entry Capacity Auction Revenue - TO Commodity Charges

- 2.11 National Grid currently levy a uniform TO Entry Commodity charge at Entry Terminals to correct for under-recovery of allowed income from Entry Capacity auctions. The target revenue for entry is 50% of the allowable TO revenue remaining after revenue recovered from the DN Pensions charge has been netted off; the remaining 50% is targeted at exit Users.
- 2.12 TO Entry Commodity Charges have increased year on year due to growing under-recovery of Entry Capacity Revenue.

Entry Capacity Neutrality Arrangements

- 2.13 Currently, revenues from the sale of Entry Capacity, which are obtained through auctions held on the Gas Day, are streamed into the SO Control. The revenues are used to offset Entry Capacity Buyback costs, through the neutrality mechanism.
- 2.14 These arrangements were put in place to provide linkage between Entry Capacity sold within-Day and potential buyback costs arising from the sale of that Entry Capacity.
- 2.15 Net costs or revenues are shared for each gas day between Users prorated to their Entry Capacity holdings. The within-day capacity sales revenue is streamed to the SO allowed revenue and is, therefore recovered via the SO Commodity charge.

Entry Capacity Surrender

- 2.16 Users may offer to surrender firm Entry Capacity and there has been a working practice for National Grid to take zero priced offers.

Licence and UNC Frameworks

- 2.17 Any proposed change to reserve price discounts may need to be reflected in National Grid's Gas Transporter Licence in respect of the NTS and may need to be reflected in the Uniform Network Code (UNC). Such changes would need to be progressed under separate governance processes to any charging methodology proposals.
- 2.18 The following aspects would need to be considered;-
- NTS Licence and the UNC⁴ references to applying a zero price in an entry auction and any associated conditions for such application
 - NTS Licence and UNC arrangements relating to streaming of revenues from within-Day Entry Capacity sales.

⁴ Uniform Network Code Transportation Principal Document Section B2.4.13 (f)

3 Issues

- 3.1 National Grid is concerned that the continued use of discounted reserve prices in short term auctions may continue to generate effects that might be considered undesirable.
- 3.2 Users may hold back from bidding for capacity in the longer term auctions, thus undermining locational signals for Entry Capacity in all auctions and undermining long-term signals for incremental capacity.
- 3.3 Discounted or zero short term reserve prices may seem attractive when capacity is perceived to be in plentiful supply, but can lead to high and unpredictable capacity prices when that same capacity becomes scarce. Discussions with the industry via the Gas Transmission Charging Methodology Forum⁵ have indicated that stable, or at least predictable, prices were preferable.
- 3.4 New entry points may be at a disadvantage in that no short term discounted firm capacity is available. Effectively new participants, who are not be able to benefit from the entry discounts may, through the TO Entry Commodity Charge, be cross-subsidising existing participants.
- 3.5 Reserve price discounts may be a factor that inhibits Entry Capacity trade at ASEPs with unsold Obligated NTS Entry capacity where some Users may have surplus capacity holdings and others are seeking short term rights.
- 3.6 Applying a discounted reserve price policy unconditionally for firm capacity short term auctions has also contributed towards higher commodity charges arising from under-recovery in the long term Entry Capacity auctions. The TO Entry Commodity Charge was designed as a correction mechanism for under-recovery of allowed revenue from auctions. Using this charge to collect a large amount of under-recovered income from Entry Capacity auctions may result in a redistribution of charges from Users acquiring Entry Capacity at a discounted rate to those Users that have previously paid a “full” rate for capacity.

⁵ <http://www.nationalgrid.com/uk/Gas/Charges/TCMF/>

4 New and Recent Developments

- 4.1 There have been a number of key changes within the regime that might influence Users' strategies for acquisition of Entry Capacity in long term auctions and hence might influence the impact of Entry Capacity discounts.
- Introduction of Transportation Model based Prices
 - Trades & Transfers
 - Changes to Entry Baselines
 - Entry Auction Revenue
 - Discretionary release of Interruptible Entry Capacity

Entry Baseline Changes

- 4.2 Gas Entry Capacity baselines were modified as part of the 2007-2012 Transmission Price Control Review (TPCR). In aggregate there is now less baseline Entry Capacity.
- 4.3 As set out in the 27 July Ofgem Open letter, in view of industry concerns, Ofgem has decided to re-consult on the baseline figures as implemented in the March 2007 Decision and reconsider the matter. The baseline review involves three stages. The preliminary 3 October 2007 consultation document on alternative allocations of current TPCR baselines forms the first stage. The next stage will be a second consultation document to be published by end of November/early December which will address potential increases to baselines, as well as issues raised in response to this document and the National Grid Summary Report on Entry Capacity Baseline Workshops which were held during August 2007 and September 2007. The second document will also include an impact assessment. The final baseline review document will be the Ofgem decision document which will aim to have NTS entry baselines finalised by 1 April 2008.

Trades & Transfers

- 4.4 As part of the 2007-2012 Transmission Price Control Review (TPCR) new obligations were placed on National Grid to provide transfer mechanisms for Obligated NTS Entry capacity. The objective of these new obligations was to reduce the risk of not fully utilising the existing network assets by enabling capacity that is not being used at a certain point of the network to be moved to another point on the network where users value it most. The concept was to facilitate increases in Obligated NTS Entry capacity at some terminals and corresponding reductions at others. As a consequence UNC modification proposal 0169 was implemented which facilitates the transfer of unsold capacity and trade of sold capacity between ASEPs for the period between October 2007 and March 2008. These processes are undertaken in a single combined mechanism based on a pay-as-bid auction.
- 4.5 Users wishing to offer to trade capacity which they already hold, notify National Grid of the maximum capacity they are willing to surrender and at which ASEP. Users bid subject to the reserve prices in a single auction. Capacity is relocated from 'donor' ASEPs according to a merit order sequence, then, for each ASEP in the merit order, capacity is allocated first from the remaining unsold capacity and secondly from surrendered capacity.

Transportation Model

- 4.6 The introduction of a Transportation Model within the Charging Methodology to set NTS capacity prices (NTS GCM01) has led to Obligated NTS Entry Capacity reserve prices for long term auctions being more reflective of costs incurred in making capacity available compared to the previous UCA based prices. As a consequence, if the quantity of capacity allocated in long term auctions remained unaltered there would be higher recovery of allowed TO revenue, however, the higher reserve prices may influence Users' strategies for acquisition of Entry Capacity in long term auctions.

Entry Auction Revenue

- 4.7 From 1st October 2007 the TO Entry Commodity charge rate has been set to zero as a result of the revenue implied by the 2007 AMSEC auction and forecast revenue from the remaining rolling monthly (RMSEC) NTS Entry Capacity auctions. Actual revenue from the remaining RMSEC auctions and revenue resulting from the Entry Capacity Trade & Transfer processes, introduced through UNC Modification Proposals 0169, will result in TO Entry revenue over-recovery should the over recovery mechanism be ineffective⁶.
- 4.8 Much of the industry concern regarding the Entry Capacity discounts were linked to concerns regarding TO under-recovery and hence there is no longer the same urgency in regard to proposing changes to the Charging Methodology.

Discretionary Interruptible Entry Capacity

- 4.9 National Grid releases Interruptible NTS Entry Capacity through a Daily Interruptible System Entry Capacity (DISEC) Auction process. The quantity of Interruptible NTS Entry Capacity that must be released in respect of any Aggregate System Entry Point (ASEP) for any day is an amount that is equal to the Daily Average Unutilised Firm Capacity. This is known as the 'use it or lose it' (UIOLI) calculation.
- 4.10 In addition to the UIOLI quantity and as a result of the implementation of UNC Modification Proposal 0159 on 1st September 2007, National Grid has the discretion to release additional quantities of interruptible capacity.

⁶ The prevailing TO entry over recovery mechanism was modified via Charging Methodology Proposal NTS GCM 09 and is the subject to further modification proposals NTS GCM 10 and 11.

5 Options for Revising the Charging Methodology

- 5.1 This section sets out the three options for each of the three daily auction types, outlined within GCD04, which might address the issues associated with NTS Entry Capacity Baseline Reserve Price discounts. The aim should be to achieve the charging obligations in the licence and be consistent with the EU Regulations.
- 5.2 Table 5.1 provides a summary of options for discounts, which are then defined in more detail. Options for each auction type could be considered in any combination from the matrix below e.g. Option 1 for Day-ahead, Option 2 for within-Day and Option 3 for interruptible, or Option 2 for all three auction types, etc. QSEC, AMSEC and RMSEC do not have discounts.

Table 5-1:

Options for Discount Factors for Entry Capacity Reserve Prices

Daily Auction Type	Option 1 (Remove)	Option 2 (Conditional)	Option 3 (Retain)
DSEC Day-ahead (Firm)	0%	33.3% Conditional*	33.3%
DSEC Within-Day (Firm)	0%	100% Conditional*	100%
DISEC (Interruptible)	N/A	100% Conditional*	100%

* see Option 2 description.

Option 1 Removal of discounts for Obligated NTS Entry Capacity reserve prices for firm NTS Entry Capacity

This option proposes that:

- 5.3 Discounts are removed for Obligated NTS Entry Capacity reserve prices for firm NTS Entry Capacity unconditionally.
- 5.4 For the avoidance of doubt, this proposed option would not change the discount applied to Daily Interruptible NTS Entry Capacity

Option 2 Conditional application of discounts for Obligated NTS Entry Capacity reserve prices for NTS Entry Capacity

This option proposes that for each ASEP:

- 5.5 Current discounts for Entry Capacity are only applied if all or a significant proportion [90%] of the capacity available in Quarterly and Monthly auctions is sold.
- 5.6 Current interruptible discounts are only applied if all or a significant proportion [90%] of the firm capacity available is sold.

Option 3 Retention of discounts for reserve prices for NTS Entry Capacity

This option proposes that:

5.7 There is no change to the discounts for reserve prices for NTS Entry Capacity.

Discussion of option 1 – removal of discounted reserve prices for firm NTS Entry Capacity

- 5.8 This may encourage more bidding in longer term auctions and help Users justify such decisions since the “wait and see” possibility of zero priced firm capacity would no longer be available. Greater participation would thus provide stronger long-term investment signals for incremental capacity and stronger signals as to which locations are required.
- 5.9 Discount removal may help stabilise short term capacity prices if previous auction rounds provide timely signals for efficient NTS investment such that the demand and need for prompt capacity can be satisfied.
- 5.10 New entry points would not be competing with existing entry points that may benefit from firm NTS Entry capacity being available at discounted reserve prices in short term auctions.
- 5.11 Users with surplus long term capacity holdings at ASEPs with unsold capacity should have more opportunity of trading to others seeking short term rights.
- 5.12 Discount removal would be expected to put downward pressure on TO Commodity charges since any reliance on “free” or discounted Daily firm capacity would be removed and greater revenues would be expected from greater capacity sales ahead of the Day at non-discounted prices.
- 5.13 Clearance allocation and price discovery of daily capacity might be inhibited if the associated uncertainty meant that Obligated NTS Entry Capacity reserve prices were higher than the value to Users. The short term market value is difficult to predict in advance, as it will be dependent on many factors, including:
- Levels of Obligated NTS Entry capacity and remaining unsold Obligated NTS Entry capacity
 - Levels of competition at an entry point
 - Perceptions of scarcity of capacity, due to constraints on the system
 - Historical buy-backs seen at the entry point
 - Contractual obligations
 - User portfolios
 - Daily Balancing requirements
 - Other markets
 - Seasonal effects
 - Effects of reduced Obligated NTS Entry Capacity levels, a Transportation Model, and potentially Transfers and Trades
- 5.14 If capacity is expected to be scarce at an entry point, it is likely that there will be an incentive to pay a price higher than zero for capacity. If a User has a requirement to flow gas at a specific entry point, but does not hold capacity for the flow desired, it is also possible that they are prepared to pay a price for that capacity. Thus it is possible that the use of a zero reserve price for daily auctions is correct in these circumstances, as it will enable the market value of the capacity from being discovered. This option for firm capacity might however lead to greater demand for interruptible capacity and this is considered further in discussion of Option 2.

Discussion of option 2 – conditional removal of discounted reserve prices for NTS Entry Capacity

- 5.15 For firm capacity the condition needs to provide an indication that there might be sufficient competition at an entry point.
- 5.16 If the “competition for firm” condition is not satisfied then the same effects to those of option 1 would be expected since non-discounted reserve prices would apply.
- 5.17 Where the “competition for firm” condition is satisfied (i.e. there is indication of sufficient competition) then there would be opportunity for auctions to reveal the value of Daily capacity, whether it be above or below the reserve prices. This should address any concern about clearance allocation and price discovery as set out above in 6.11 for Option 1.
- 5.18 If firm Entry Capacity discounts were removed and discounts were unconditionally retained for interruptible capacity this might lead to “a flight from firm” and greater demand for interruptible Entry Capacity. While Users might demand interruptible capacity at an entry point if all firm capacity were not sold, then Users, by acquiring interruptible capacity, would actually be accessing firm capacity due to the minimal expectation of interruption (scale back). The zero reserve price for interruptible capacity resulting from a 100% discount might therefore only be appropriate if most of the firm capacity had already been sold at the ASEP. An alternate but equivalent approach might be to only release of interruptible capacity once most of the firm capacity had been released. This would require a UNC change.

Discussion of option 3 – Retain all discounts for reserve prices for NTS Entry Capacity

- 5.19 Changes such as Obligated NTS Entry Capacity level reduction, Transportation Model based capacity charges and Entry Capacity transfers and trades (see Section 4) may lead to a combination of more effective competition at some NTS entry points and minimised under-recovery of revenue in auctions and therefore reduction in the TO Entry Commodity Charge.
- 5.20 If some NTS entry points still had a lack of effective competition then the opportunity would remain to acquire Daily firm capacity at little or no cost and, it might be argued, thereby receive a cross-subsidy from other Users.
- 5.21 If some NTS entry points had a low likelihood of interruption but the opportunity remained to acquire interruptible capacity at little or no cost it might be argued there would be a cross-subsidy from other Users.
- 5.22 If at some NTS Entry points Users still did not procure their Entry Capacity requirements well in advance of the gas day then investment signals would be weak or absent at these points. While this might be appropriate if no incremental capacity were required, it could lead either to constraints or calls for investment with weak or absent User commitment.

6 Summary of Responses

National Grid NTS received 5 responses to its consultation on NTS GCD 05; two were in support of removing firm entry reserve price discounts, one offered comments and two were not in support. None of the responses were marked as confidential, and copies of the responses have been posted on the Gas Charging section of the National Grid information website.

Support for the Proposal

Respondent		View	Note
Total E&P	TOTAL	Support removal of discounts (Option 2)	TOTAL “believe that in the absence of material likelihood of interruption, NTS interruptible capacity should not be auctioned at zero reserve price.”
EDF Energy	EDF	Support removal of firm discounts (Option 1) but not Interruptible discounts.	EDF comments “UNC 2.5.10 defines interruptible capacity as: “an amount of NTS Entry Capacity equal to the daily average unutilised firm capacity.” As such therefore 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.
E.ON UK	EON	Do not support changing the current discounts (Option 3)	EON “does not believe it is necessary to remove or alter the current reserve price discounts” and “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.”
RWE npower	RWE	Do not support changing the current discounts (Option 3)	“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.”
Statoil UK	STUK	Comments	“While welcoming National Grid’s thoughts on potential changes STUK would seek to understand the nature of the issues prior to supporting or limiting the industry to one of three solutions presented.”

Detailed Responses

This paper has discussed the issues relating to the setting of daily entry capacity auction reserve prices, specifically the removal (Option1), or the conditional application (Option 2) of discounts applied to Day-ahead, within-Day and interruptible entry capacity reserve prices. The paper has also considered retaining discounts (Option 3).

Responses by discussion question:

Q1. The principle that, in the absence of an indication of effective competition, NTS Entry capacity reserve prices should not be discounted for Daily auctions of firm capacity.

RWE comments “We believe that wider regime changes will reduce the future availability of daily firm capacity such that there will be more competition for that which is available.”

EON notes “the primary reason that shippers leave a proportion of their capacity procurement until the day or day-ahead is to manage volume risk efficiently and economically. The apparent “lack” of ‘effective competition’ is not a suitable measure to use as it merely concentrates on what the current competition for capacity is and ignores the effect that new entrants could have at a particular entry point. Therefore, removing a discount based on current perspectives on behaviour at a terminal could discriminate unduly against new entrants and may distort locational signals by forcing Users to procure capacity at other, relatively ‘cheaper’ ASEPs.”

TOTAL comments “We believe that in the absence of effective competition NTS Entry Capacity reserve prices should not be discounted for Daily Auctions of Firm Capacity.”

RWE comments that under the 2007 to 2012 price control settlement, the regime is changing “with reduced baselines and new requirements on National Grid Gas (NGG) to maximise the use of existing transmission assets via obligations to enable the transfer, trade and substitution of capacity between entry points. These increase the likelihood that unsold capacity may not be available capacity at low or zero cost day-ahead or within-day. Therefore, we believe that shippers will be more likely to secure their Entry Capacity in medium and long-term auctions.”

STUK “is concerned that appropriate allocation of Entry Capacity prices occurs. It is with interest therefore that Statoil considers the comments of National Grid that the use of discounted reserve prices in short-term auctions has generated effects that might be considered undesirable. STUK would wish to ensure that there are not inequalities in Entry Capacity charges which create a cross subsidisation between parties.” STUK comments “The paper also makes the assertion that variation in Entry Capacity prices seen when capacity is scarce is partly due to zero/discounted reserve prices. STUK struggled to find the logic in this statement. It would seem more logical that as with any product, scarcity will usually cause increased prices in relation to the products relative elasticity.”

EON “does not believe it is necessary to remove or alter the current reserve price discounts applied to firm and interruptible short-term capacity. We have a longstanding general concern that reliance solely on auction signals is not the most efficient and economic approach to operating the National Transmission System. We believe NG must adopt a holistic approach to incremental investment in the System that can still continue to value long-term auction signals needed for investment, but which must be supported and reinforced by the use of centralised infrastructure planning. We 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.”

TOTAL comments “We are confident that implementation of Option 2 is in line with our statements above and would better facilitate the objectives of achieving cost-reflectivity, promoting efficiency and avoiding undue preference.” “If capacity is offered at discounted prices only when 90% of the capacity available in the QSEC, AMSEC and RMSEC is sold, this minimizes the risk of NG facing T.O under-recovery whilst at the same time making sure that the costs incurred in making capacity available at a particular entry point are recovered through Entry Capacity prices to shipper’s at that entry point. This would lead to minimal TO commodity charges and an overall system that is more cost reflective.” “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. Because of the reasons detailed above we would favor the implementation of Option 2 and believe that can be done with out delay.”

National Grid’s view

National Grid remains concerned that, in the absence of effective competition, the prices paid for on the day capacity have not been reflective of the costs incurred. National Grid recognises that a key reason that shippers leave a proportion of their capacity procurement until the day or day-ahead is to manage volume risk efficiently and economically but believes that this is not a justification for the discounts applying and actually suggests that removal of discounts may not have a negative effect on the availability of daily capacity. The question that arises is; if the discounts were to be removed, would payments based on a limited number of days of procurement reflect the costs incurred in making the capacity available?

Q2.The principle that, in the absence of a material likelihood of interruption, NTS Entry interruptible capacity should not be auctioned with zero reserve price.

RWE comments “As the availability of interruptible capacity is based on an expectation that there may be unutilised firm Entry Capacity on a gas day, this could be considered as a suitable surrogate for the likelihood of interruption as availability and risk of interruption would increase as firm flows increased.”

EON comments “Linking the cost of interruption to the material likelihood of interruption raises many complex issues and we would prefer to see more details of how NG believe this could work in practice before offering our comments on the principle. “

TOTAL comments “We believe that in the absence of material likelihood of interruption, NTS interruptible capacity should not be auctioned at zero reserve price.”

EDF comments “UNC 2.5.10 defines interruptible capacity as: “an amount of NTS Entry Capacity equal to the daily average unutilised firm capacity.” As such therefore 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. Option 2 however would place a charge associated with this capacity in certain circumstances and so would be inconsistent with the relevant licence condition to ensure that charges reflect the costs incurred by the licensee in its transportation business.”

National Grid’s view

National Grid recognises that the process for calculating the volume of “use it or lose it” interruptible capacity might suggest that interruptible Entry Capacity should be zero priced to avoid double charging. The “use it or lose it” quantity relates to sold unutilised firm capacity which has, by definition, already been paid for. The issue remains that procuring interruptible capacity when firm remains unsold, which might be the case if the firm discounts were removed, would effectively lead to the interruptible capacity being firm. In order to take into account this scenario, the release of interruptible capacity could be restricted until all firm capacity was sold. This would be achieved via a UNC change rather than a Charging Methodology change.

Q3. That secondary capacity trading of Users’ surplus holdings at an NTS entry point is inhibited by the availability, at a substantial discount, of primary capacity at the same entry point.

RWE comments “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.”

EON “would not agree with this statement. In the example cited, there seems to be a surplus of primary capacity at the particular entry point, which may indicate that there is simply no demand for capacity; irrespective of the low reserve price. Hence, whatever the price of primary capacity, the demand for secondary trading will ultimately be limited by the demand for capacity. Moreover, we would question whether there is really any need to encourage secondary trading at an ASEP when there is a surplus of primary capacity. Our view is that 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. A more pertinent issue to bear in mind is that when the trades and transfers process comes into effect, different reserve prices within a ‘zone’ may encourage Users to buy capacity at a ‘cheap’ ASEP with a view to transferring it to sold-out ASEPs with a higher reserve price within the same zone, which undermines the principle of different reserve prices for different ASEPs.”

EDF comments “An alternative option to encourage price discovery for day ahead and within day capacity would be to remove the DSEC auctions and instead rely on the secondary market to release this capacity. This would provide the secondary market with the required liquidity and allow NGG to compete with other Users for the release of sale of spare capacity in an open and transparent auction process. This mechanism would be particularly useful if NGG remained anonymous to the rest of the market when releasing this capacity. However we recognise that this Option would require significant development by the industry before it could be progressed.”

EON comments “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. Therefore, there ought to be a certain amount of capacity made available in the short-term. We already have concerns that the amount of short-term capacity held back by NG will diminish from 20% to 10% under the current Transmission Price Control (2007 onwards) and if the scarcity is then compounded by less attractive discounts, then this could lead to a significant barrier to market for new entrants.”

National Grid's view

National Grid remains concerned that the entry discounts inhibit secondary trading and hence inhibit competition as there is no incentive to enter into a trade with another User if unsold capacity is released at a zero reserve price. Removing the discount should not impact the quantity of short term capacity made available; indeed it should increase the likelihood of short term capacity being available.

National Grid welcomes EDF's contribution to the debate by highlighting the alternative option to encourage price discovery for day ahead and within day capacity of removing the DSEC auctions and instead relying on the secondary market to release daily capacity, however, this option may not be consistent with EU regulations governing transmission access obligations in regard to obligations to release short term services.

Q4. Whether it is a practical necessity to always have auctions with zero reserve price in pursuit of price discovery and clearance of Obligated NTS Entry capacity.

RWE comments “We can see merits in retaining zero reserve prices and consider that they help NGG discharge its obligations for maximising available capacity for a gas day.”

EON comments “It is critical to the economic and efficient operation of the NTS to make the full capability of the network available to Users. As the amount of capacity required in the short-term will vary considerably within-day depending on demand, the most ‘cost-reflective’ reserve price can only be zero. To impose any other reserve price in daily auctions would place an artificial restriction on true price discovery, potentially restrict access to market by new entrants and would prevent the most efficient and economic release of Entry Capacity.”

National Grid's view

National Grid does not believe that the price of capacity, based on a long run marginal cost approach, would have any impact on its obligations for maximising available capacity for a gas day. While the zero reserve price may discover the minimum price that Users will bid for NTS Entry Capacity, it clearly does not discover Users' true valuation of that capacity.

Q5. Specifically for Day-ahead NTS firm Entry Capacity auctions – should the 33% discount on NTS Entry Capacity Baseline Reserve Prices be removed, applied conditionally at each NTS entry point (indication that there is sufficient competition in play such as 90% of the capacity available in Quarterly and Monthly auctions is sold.), or retained?

RWE comments “We believe that the current discounts should be retained.”

EON comments “Trying to determine any discount that is anything other than zero or 100% is essentially an arbitrary process and there will always be arguments for and against any number that is chosen. For the sake of clarity and stability, we would prefer to see the existing arrangements for day-ahead capacity retained; particularly as we do not feel there is a problem currently. Applying ‘conditional’ reserve prices at particular ASEPs is both a barrier to market for new entrants and could be considered discriminatory.”

National Grid’s view

National Grid remains concerned that applying discounts in regard to existing ‘baseline’ capacity and not for new ASEP’s might be considered to be both a barrier to the market for new entrants and discriminatory.

Q6. Specifically for Within-Day NTS firm Entry Capacity auctions – should the 100% discount on NTS Entry Capacity Baseline Reserve Prices be removed, applied conditionally at each NTS entry point (indication that there is sufficient competition in play such as 90% of the capacity available in Quarterly and Monthly auctions is sold.), or retained?

RWE comments “We believe that the current discount should be retained and applied unconditionally. We do not support the inclusion of an arbitrary threshold.”

EON comments “it could be considered discriminatory to apply different rules regarding discounts at different ASEPs and as such would not facilitate better competition between shippers.”

EDF “believe that Option 1: ‘Removal of discounts for Obligated NTS Entry Capacity reserve prices for firm NTS Entry Capacity’ represents the best option of the three provided by NGG, however we believe that further options should also be considered in relation to the pricing of within day and day ahead firm products.”

EDF comments “In particular it would appear that the aim of the discussion document is to encourage Shippers to book longer term Entry Capacity and also to ensure that there is no cross subsidisation between ASEPs and Users who decide to implement different capacity booking strategies. As a result of encouraging Users to book capacity longer term it would also appear that the amount of under recovery from the auctions will be reduced and so the level of the TO Commodity charge will also be reduced. As recognised by NGG the impact of the recent changes to the Licence Conditions, when implemented, with regards to the transfer, trade and substitution of Entry Capacity, combined with the recent unexpected change to the Entry Capacity baselines should also encourage Users to book their Entry Capacity requirements long term. It would therefore appear that these proposals are designed to introduce a further incentive to book capacity long term, or remove the disincentive that is currently present. In addition it would also appear that changing these arrangements may encourage the development of a secondary market for trading capacity.”

“EDF Energy 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. We therefore believe that in addition to the Licence Objectives it is these two core benefits that the proposals should be judged against. As such therefore Option 3, maintaining the current arrangements, does not deliver these core benefits as it has been demonstrated that they do not encourage Users to book long term Entry Capacity and the secondary market for trading capacity has not developed significantly. Further, as recognised by NGG, Option 3 could maintain the cross subsidy between Users that are currently experienced, which is inconsistent with EC Regulation 1775/2005.”

EDF comments “Option 1 however maintains the discount, and so is consistent with the licence conditions. Further by removing the discount for day ahead and within day firm capacity this option will encourage Users to book long term capacity, and by creating a value for this capacity at the day ahead and within day stage encourage the development of a secondary market. We would however note that we believe further actions will be required to further encourage the development of a secondary market, which we have already shared with NGG.”

EDF comments “However whilst we believe that Option 1 represents the best of the options presented by NGG, we believe that this could either be developed further, or a fourth option should also be considered. 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.”

National Grid’s view

National Grid remains concerned that the Entry Capacity discounts represent a disincentive to book capacity in the long term auctions and hence limit market signals. A signal to invest might only be generated by Users’ requirements for capacity in aggregate and hence users may erroneously believe that sufficient capacity may be available on the day based on historical utilisation and their own requirements.

Q7. Specifically for Interruptible NTS Entry Capacity auctions – should the 100% discount on NTS Entry Capacity Baseline Reserve Prices be applied conditionally at each NTS entry point (i.e. only when there is a material probability of interruption such as when 90% of the firm capacity available is sold), or retained?

RWE comments “We believe that the current discount should be retained and applied unconditionally. We do not support the inclusion of an arbitrary threshold and in any the calculation of interruptible capacity contains a de facto test of probability of interruption.”

EON comments “it could be considered discriminatory to apply different rules regarding discounts at different ASEPs and as such would not facilitate better competition between shippers.”

TOTAL comments “In the same way, 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.”

National Grid’s view

National Grid is concerned that, should firm Entry Capacity discounts be removed, Users would simply purchase interruptible capacity which would then effectively be firm should firm capacity remain unsold. This suggests that interruptible capacity should either not be released or auctioned with a non-zero reserve price until all firm capacity has been sold.

Q8.The effect of discounting on other charges (e.g. TO Entry Commodity Charges) that Users may pay.

RWE comments “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.”

RWE comments that regime changes “must be considered alongside the change in the model for deriving Entry Capacity reserve prices. 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. As a consequence, the year on year changes and increased volatility of the TO commodity charge that has been observed should be reduced.”

TOTAL comments “We share National Grid’s worries over the current Entry Capacity reserve price discount system. Year on year we have seen National Grid face T.O under-recovery due to weak participation in the longer term auctions. We see 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.” TOTAL comments “We believe that shipper’s costs should be mainly due to Entry Capacity charges and only exceptionally due to the T.O commodity charge.”

National Grid’s view

This discussion paper was raised at a time when Users had expressed concerns about the increasing charge rate of the TO Entry Commodity charge. National Grid had raised a concern that the Entry Capacity discounts were contributing towards the high TO Entry Commodity rate through both the impact on daily revenue and through the disincentive to participate in the long term auctions. The outcome of the 2007 AMSEC auction has, however, led to the TO Entry Commodity charge rate being set to zero. This resulted from competition for Entry Capacity pushing up clearing prices, due to changes to baseline levels, demand for Entry Capacity exceeding availability at some ASEPS and the transferability of Entry Capacity resulting from the Trade & Transfer process, however, National Grid is concerned that high TO Entry Commodity charges may return once east coast NTS reinforcements have been completed.

Q9. When any proposed changes to discounts should be implemented or further considered?

RWE comments “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.” RWE comments “We 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. A number of regime changes have already been introduced and others are in various stages of development ahead of implementation. This creates uncertainty and undermines confidence in the regime going forward and can see little additional benefit in making further changes at this time.”

EON comments “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. Consequently, we 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.”

STUK comments “The discussion paper makes a number of observations and assumptions which STUK believe warrant further investigation by National Grid. However in the current environment of significant change in the Entry Capacity regime it is important that the materiality of these issues is confirmed prior to the definition of any program of work. In the event that National Grid can demonstrate that significant inequalities and cross subsidisation is occurring between entry points then STUK believes it is important that this is addressed as a priority. In the case that National Grid show that the significance of any inequalities and cross subsidisation is low then STUK 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.”

National Grid’s view

National Grid accepts that changes to discounts need to be considered in light of any further changes to the baseline levels and enduring Trade & Transfer processes.

7 Way Forward

7.1 National Grid will continue to keep the Charging Methodology under review in compliance with its transportation Licence in respect of the NTS and in light of any further changes to baseline NTS Entry Capacity and capacity access processes. National Grid accepts that changes to discounts need to be considered in light of any further changes to the Baseline Entry Capacity levels and enduring Trade & Transfer processes and hence intends to further investigate the issues via the Gas TCMF in 2008.

Appendix A: Licence Relevant Objectives and EU Gas Regulations

The National Grid Gas plc Gas Transporter Licence in respect of the NTS requires that proposed changes to the Charging Methodology shall achieve the relevant methodology objectives.

Where transportation prices are not established through an auction, prices calculated in accordance with the methodology should:

- 1) Reflect the costs incurred by the licensee in its transportation business;
- 2) So far as is consistent with (1) properly take account of developments in the transportation business;
- 3) So far as is consistent with (1) and (2) facilitate effective competition between gas shippers and between gas suppliers.

Where prices are established by means of auctions, either

- 4) No reserve price is applied or
- 5) Reserve prices are calculated at a level that promotes efficiency, avoids undue preference in the supply of transportation services and promotes competition between gas shippers and between gas suppliers.

National Grid is obliged to keep the NTS Charging Methodology under review at all times for the purposes of ensuring that it achieves the relevant objectives.

National Grid also has an obligation to use all reasonable endeavours to ensure that obligated Entry Capacity is offered for sale in at least one clearing auction providing that this does not contravene wider Licence obligations including methodology objective (5) listed above.

EC Regulation 1775/2005 on conditions for access to the natural gas transmission networks (binding from 1 July 2006) states that the principles for network access tariffs or the methodologies used to calculate them shall:

- Be transparent
- Take into account the need for system integrity and its improvement
- Reflect actual costs incurred for an efficient and structurally comparable network operator
- Be applied in a non-discriminatory manner
- Facilitate efficient gas trade and competition
- Avoid cross-subsidies between network Users
- Provide incentives for investment and maintaining or creating interoperability for transmission networks
- Not restrict market liquidity
- Not distort trade across borders of different transmission systems.

All but the last of the principles listed above map onto the objectives for National Grid's Transmission Transportation Charging Methodology. In terms of cross border trade, the Regulation recognises that funding for network investment may require different tariffs across different transmission systems.