

Proposed revision:	<b>Modification Proposals to the Gas Transmission Transportation Charging Methodology NTS GCM03 'Introduction of an SO Commodity Charge for NTS Storage Facilities'</b>		
Decision:	<b>The Authority<sup>1</sup> considers that the modification is not requisite for the purpose of achieving the relevant methodology objectives and directs NGG NTS not to make the proposed change<sup>2</sup></b>		
Target audience:	<b>NGG and other interested parties</b>		
Date of publication:	<b>31 January 2007</b>	Implementation Date:	<b>N/A</b>

### **NTS GCM03 Introduction of an SO Commodity Charge for NTS Storage Facilities**

On 20 December 2006 National Grid Gas (NGG) pursuant to its National Transmission System (NTS) licence submitted to the Authority the Conclusions Report NTS GCM03 Introduction of an SO Commodity Charge for NTS Storage Facilities under Standard Special Condition A5 (Obligations as Regard Charging Methodology) (the "Condition"), regarding proposals to amend its charging methodology by introducing a System Operator (SO) commodity rate that will apply to all NTS storage input and output gas flow allocations (the "Storage SO Commodity Rate") at a lower rate than that currently applicable for all entry and exit gas flow allocations (the "Standard SO Commodity Rate").

The Storage SO Commodity Rate would be different from the Standard SO Commodity Charge as it would exclude the costs of compressor gas and Operating Margins, both of which are included in the Standard Commodity Rate. In NGG's view these costs are not driven by the operation and ongoing support of NTS storage facilities and hence excluding them would minimise the potential for double charging.

On 22 December 2006 NGG provided the Authority with the Final Modification Report for an associated Uniform Network Code modification 0120V: Introduction of a SO Commodity Charge for NTS Storage Exit Flows (the UNC modification).

#### **Background to the proposed revisions**

On 18 January 2002, Ofgem decided not to veto Pricing Consultation (PC) 70, 'NTS System Operation Transportation Charges'. PC 70 replaced the National Transmission System (NTS) standard commodity charge with a SO commodity charge, which has applied since 1 April 2002.

<sup>1</sup> The terms 'the Authority', 'Ofgem' and 'we' are used interchangeably in this document. Ofgem is the Office of the Gas and Electricity Markets Authority, the regulator of the gas and electricity markets in Great Britain.

<sup>2</sup> This document also constitutes notice of the reasons for this decision as required by section 38A of the Gas Act 1986.

The SO commodity charge is levied on all gas conveyed on the NTS, except flows in and out of storage sites (although storage own use gas would still attract the standard SO commodity charge) and recovers the following:

- Compressor costs
- Unaccounted-for gas costs;
- Internal costs such as administration costs of the system operation function and data handling;
- Operating margins costs such as the cost of having booked gas in LNG for supporting the safe rundown of firm load;
- Exit capacity TO costs such as. outperformance on the incentive of constrained LNG;
- Deemed interruption costs which flow from the 100% TO exit capacity charge discounts received by interruptible users and are therefore related to the amount of interruptible load;
- Forecast K costs associated with under or over recovery against maximum allowed SO revenue; and
- Incentive payments to NGG to for its performance under the SO incentive schemes as well as payments to shippers where the NGG under performs against its incentive targets).

PC 70 provided that the SO commodity charge should be applied to NTS flows into gas storage sites. However, the basis on which the SO commodity charge is to apply to gas storage sites was the subject of a number of Network Code modification proposals (532,544, 547<sup>3</sup>) which were rejected by Ofgem.

One of Ofgem's main concerns in relation to the proposed code modifications (532, 544 and 547) was that the proposed charge was not cost reflective and effectively resulted in storage users being subject to double charging. A large share of the SO commodity charge consists of overheads and it would not be cost reflective to charge storage users a full SO commodity charge both on the gas flowing into storage and the gas flowing out of storage. Ofgem therefore concluded that these code mods would not facilitate the achievement of the code relevant objectives set out in the licence. Ofgem also indicated that a discounted SO commodity charge based on physical flows might be more appropriate.

### **NTS GCM03**

NGG NTS is proposing NTS GCM03 to amend its charging methodology by introducing a Storage SO commodity rate that would be applied to all NTS storage input and output gas flow allocations (except storage own use gas) at a lower rate than the Standard SO Commodity Rate currently applicable for all entry and exit gas flow allocations.

The Storage SO Commodity Rate would be determined by excluding the costs of compressor gas and Operating Margins both of which are included in the Standard Commodity Rate. NGG is of the view that these costs are not driven by the operation and ongoing support of NTS storage facilities and hence excluding them would minimise the potential for double charging. Any adjustment in charges arising from the outcome of the SO incentives schemes would remain with the Standard SO Commodity Rate.

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<sup>3</sup> [http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/3233\\_532-545-547.pdf?wtfrom=/ofgem/work/index.jsp&section=/areasofwork/gasgovernance](http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/3233_532-545-547.pdf?wtfrom=/ofgem/work/index.jsp&section=/areasofwork/gasgovernance)

The reduced SO Commodity Rate (i.e. the storage commodity rate) would not apply to physical flows but instead would apply to commercial or nominated flows into and out of storage. In order to calculate which proportion of SO commodity costs should be charged to storage users, NGG NTS divides the total physical flows into and out of storage sites by the total annual system flows.

Initially, NGG had proposed that the ratio of costs attributable to storage users should be based on nominated flows (given that charges are based on nominated flows) but in the light of the overwhelmingly negative responses to NTS GCM03, NGG has changed its view on this. The ratio of physical storage flows divided by total annual system flows would be 0.043085. If however, nominated flows had been used a larger proportion of costs would have been attributed to storage as the proportion would have been 0.047658.

Based on the same forecast of storage gas flows and SO costs used in Consultation Paper GCM03, this approach would result in a revised figure for the proposed SO Storage Commodity charge of 0.0055 p/kWh, compared to the original proposed figure of 0.0065 p/kWh. This would be expected to generate SO revenue of £4.4m for the current formula year. These revised figures would not alter the predicted value of the standard SO commodity rate of 0.0112 p/kWh given in the Consultation Paper GCM03.

### **Responses to NTS GCM03**

NGG received 12 responses, of which 2 were confidential. Eleven respondents did not support the proposal and one respondent gave conditional support, its support being conditional on the proposals being cost reflective. Respondents give many reasons why they do not support the proposals, but the main reasons are:

- (i) the proposal lacks transparency and is not supported by sufficient analysis;
- (ii) the proposed charge is not cost reflective;
- (iii) the proposal leads to the potential discriminatory and favourable treatment of storage users;
- (iv) conversely to (iii) the proposal does not recognise the benefits of storage for NTS;  
and
- (v) the proposal would have a negative impact on the storage business.

Other objections that have been raised are that the proposal would limit investment in storage and reduce storage cycling which might impact on the efficiency of the system as a whole with potential security of supply implications. It has also been argued that it would increase the wholesale gas price. Concerns were also raised in respect to an implementation date during the current gas year.

#### **(i) Lack of transparency and insufficient analysis**

A number of respondents criticise the lack of transparency, the lack of underlying data and analysis. It has been pointed out that information provided by NGG was of a qualitative nature rather than of a quantitative nature, which makes it difficult to judge whether cost elements are appropriately included or not.

## **(ii) Lack of cost reflectiveness**

The majority of respondents do not believe that the proposal will result in cost reflective charges. It is argued that a large number of the costs such as internal costs are fixed costs which are not related to nominated flows. One respondent therefore argues that a fixed annual charge would be more appropriate. Another respondent suggests that internal costs should be linked to the number of meters rather than contractual flows.

It is also pointed out that shrinkage costs which are captured by the SO commodity charge are related to the number of meters but not to contractual flows. Hence, as a consequence of this proposal, it is likely that there will be an over-recovery from storage users because a net flow of zero where the contractual flows are deemed 10 in and 10 out would still attract charges even though no gas has actually flowed through the meter.

Several respondents argue that inappropriate costs have either been included in or excluded from the proposed SO Storage commodity charge. One respondent is opposed to the exclusion of compression costs and operating margins from the charge because compressor costs are a function of the distance the gas travels and there are no restrictions on the locations of storage facilities in relation to distance from entry points. Hence, the rationale of this exclusion is unclear to the respondent.

This respondent also states that the exclusion of operating margins would be on the basis that there is no need to support firm exit flows at or around peak periods as storage is interruptible. However, the respondent notes that the interruptible status of storage users would be dependent on the outcome of UNC Modification Proposal 0116V 'Reform of NTS offtake arrangements' and its variants (interruptible status is not contemplated under the alternative proposal 0116v), which would only apply from October 2010 if implemented.

Another respondent estimates that of the £5.3m per year which the SO Storage Commodity charge would raise, that respondent would bear 77% of these costs which amount to £4.081m per year. This respondent concludes that the proposed charge does not reflect the NGG's costs, is discriminatory and will interfere with effective competition.

## **(iii) Potential discriminatory treatment and favourable treatment of storage users**

One respondent argues that the proposals result in discriminatory treatment between storage connection points and other offtake points. It considers that the charge should be based on the same principles as at other offtake points and should be levied on gas that is actually offtaken.

This respondent refers to EU gas regulation 1775/2005 on conditions for access to gas transmission networks, and also refers to a draft explanatory note on tariffs shortly to be issued by DGTREN which states that, "Tariffs for identical services offered by individual TSOs should be identical. Tariffs must be the same for the same service for all system users. Discounts or any other special treatment is not allowed anymore". The respondent further argues however, that this is not a position that the industry generally supports and considers that it would not be unduly discriminatory to provide different services to different types of offtakes.

The same respondent also questions whether the NGG's service of providing capacity and conveying gas to storage offtakes is different from that provided at other offtakes. If the service is different then it may be appropriate to apply a different charge.

The respondent does not understand the argument for applying a different commodity rate for storage own use gas and gas which uses the same transportation network and route that is stored and subsequently re-injected into the network. It suggests that there was a case for this when the whole system, including storage was owned and operated by the same entity; however this is no longer the case.

Another respondent does not consider that storage sites should be treated like any other NTS exit points but it questions why this distinction does not apply to other exit points such as GDN and smaller industrial NTS supply points.

One other respondent states that it has no objection to levying different commodity rates on Storage Operators to other Users, but questions whether this is consistent with Ofgem's previously stated views on NGG's licence and Gas Act 1986 obligations to avoid any undue discrimination in its transportation business.

This respondent refers to their response to UNC Modification Proposal 0116a (Enduring Offtake Arrangements) where it argues that the assumption that all NTS Offtake Users should be treated the same is not appropriate.

It quotes a legal view it has received from counsel and concludes that where "various classes of NTS User are not materially comparable, that there are valid reasons for their different treatment and as such different treatment is appropriate." The respondent further states "that UNC Modification Proposal 0120 in its current form would support its argument for validly treating NTS Offtakes differently through positive discrimination, by levying a reduced commodity charge rate on storage flows.

#### **(iv) Benefits of storage on NTS**

Six respondents state that they do not believe the proposed charge takes account of the benefits that storage facilities provide to the NTS, by creating transmission capacity and releasing gas onto the system when demand is high. One respondent suggests that where storage sites contain their own compression and re-deliver gas back to the NTS at higher pressure, this benefit of providing compression to the NTS needs to be deducted from any proposed charge.

#### **(v) Negative impact on storage business**

Six respondents express concern with the potential impact the proposed charge could have on the storage business, particularly now that the UK becomes increasingly reliant on gas sourced from abroad and the need for storage investment increases.

#### **Conditional support**

One respondent gives conditional support as long as the proposals are cost reflective.

#### **NGG's recommendation in NTS GCM03**

Having considered all the respondents' views, NGG is of the view that the introduction of a cost-reflective SO commodity charge for NTS storage facilities as proposed under NTS GCM 03 would be requisite for the purpose of achieving the relevant methodology objectives. The current situation whereby Users of NTS storage facilities do not incur any SO commodity charge is, in its view, inappropriate as it results in Users at other NTS Entry and Exit Points cross-subsidising such Users. In developing this proposed charge, National Grid NTS believes that it has taken into account the views of the Authority in its decision letter on Network Code Modification Proposals (0532, 0544 & 0547), and developed a charging methodology that better reflects the actual costs incurred, which seeks to avoid double-accounting.

### **The Authority's decision**

The Authority has considered the issues raised by the consultation responses<sup>4</sup> and NGG NTS Conclusions Report NTS GCM03. The Authority has concluded that the modification is not requisite for the purpose of achieving the relevant methodology objectives as set out in Standard Special Condition A5 'Obligations as Regard Charging Methodology' paragraph 5

- (a) save in so far as paragraphs (aa) or (d) apply, that compliance with the charging methodology results in charges which reflect the costs incurred by the licensee in its transportation business;

and

- (c) that, so far as is consistent with sub-paragraphs (a) and (b), compliance with the charging methodology facilitates effective competition between gas shippers and between gas suppliers;

The Authority has therefore given a direction that NGG NTS should not make any modification to its charging methodology by the introduction of an SO Commodity Charge for NTS Storage Facilities as set out in NTS GCM03 (Introduction of an SO Commodity Charge for NTS Storage Facilities).

### **Reasons for the Authority's decision**

*"Compliance with the charging methodology results in charges which reflect the costs incurred by the licensee in its transportation business" – SSC A5(5)(a)*

The Authority is not convinced that the proposed application and the proposed calculation of the storage SO commodity rate would result in a cost reflective charge. The Authority notes that the main components of the proposed storage SO commodity charge are internal costs and deemed interruption. Internal costs relate to administration of the system operation function and data handling. These costs are not related to the level of commercial flows of gas into or out of storage facilities.

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<sup>4</sup> The consultation responses can be found at:  
<http://www.nationalgrid.com/uk/Electricity/Balancing/consultations/>



The other main component is deemed interruption costs. These costs flow from the 100% TO exit capacity charge discounts received by interruptible users. These costs are therefore related to the amount of interruptible load. As with internal costs, these costs are not related to commercial flows.

On this basis, and consistent with responses received we are concerned that the proposed charge will not be cost reflective.

In addition, as has been pointed out by a respondent, it is not clear why compressor costs should be excluded from the storage SO commodity charge. It could indeed be argued that such blanket exclusion is inappropriate as there may be scenarios where the injection or withdrawal of storage triggers compression on the NTS, i.e. for example if a user wants to inject into a storage facility on a cold winter day.

In summary therefore, we consider that the relevant methodology objective set out in Standard Special Condition A5(5)(a) (Obligations as Regard Charging Methodology) has not been met.

*“Compliance with the charging methodology facilitates effective competition between gas shippers and between gas suppliers” – SSC A5(5)(c)*

In the Authority’s view, the relevant methodology objective, “that compliance with the charging methodology facilitates effective competition between gas shippers and between gas supplies”, which is set out in Standard Special Condition A5(c), is unlikely to be met as certain users would face a disproportionate and unjustifiably large share of the SO commodity costs.

Whilst it is important to avoid double charging, it is equally important to ensure that any proposals that are brought forward by NGG NTS are sufficiently cost reflective. In the absence of cost reflectivity there is a danger that pricing proposals could hinder the securing of effective competition between shippers. In this respect, the concerns raised by respondents regarding discrimination are relevant.

### *Transparency*

A number of respondents criticise the lack of transparency, the lack of underlying data and analysis, which makes it difficult to judge whether cost elements are appropriately included or not.

Going forward, it will be important that the development of an appropriate cost reflective SO commodity charge for storage users addresses these concerns. It is important that a robust consultation process is followed, which ensures that sufficient information is made available to interested parties to reach a view on the proposal.

Ofgem is disappointed with the content of this pricing consultation NTS GCM03 especially given that this issue was first subject to a number of network code mods more than three years ago. Going forward, Ofgem expects to see a proposal for the introduction of a reduced SO commodity charge for storage users which is cost reflective and which is arrived at through a transparent and robust process. Ofgem continues to believe that, in principle, storage flows should not be excluded from the application of the SO commodity charge and that any particular benefits provided by storage sites to NGG NTS as system operator should

not be factored into the calculation of the SO commodity charge. Going forward storage flows on the network are likely to increase and hence it is going to become increasingly important for this issue to be resolved to ensure that storage users bear some of the costs associated with system operation as do other users.

Yours sincerely

**Robert Hull**  
**Director, Transmission**

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