Modification proposal:	**Modification Proposal NTS GCM05 'NTS Exit (Flat) Capacity & Exit Reform'**		
Decision:	**The Authority[1] has decided not to veto this proposal[2]**		
Target audience:	**NGG NTS and other interested parties**		
Date of publication:	**31 March 2009**	Implementation Date:	**1 April 2009**

Background to the modification proposal

As part of the exit charging arrangements which are in place until October 2012, National Grid Gas (NGG) levies charges for firm National Transmission System (NTS) exit capacity. These charges are calculated on a nodal basis except in the case of Gas Distribution Network operators (GDNs) where they are calculated on a zonal basis. NTS exit interruptible capacity does not attract NTS exit capacity charges.

The Gas Transmission Transportation Charging Methodology contains the concept of 'Charges Foregone' which reflect the charges interruptible sites would pay if they were taking firm capacity. These charges foregone are included in NGG's gas transporter licence as System Operator (SO) allowed revenue (levied via the SO commodity charge) and identified as Transmission Owner (TO) actual (collected) revenue. Currently, interruptible credits are also paid by NGG to interruptible exit users for each day of interruption in excess of 15 days.

In January 2009, the Authority approved Unified Network Code (UNC) modification 195AV which implements NTS exit reform from October 2012. As part of the exit reform proposals the modification introduced NTS (Flat) Exit capacity, which will be available as Enduring, Enduring Annual, Daily and Off-Peak Daily (interruptible) capacity products. The Enduring and Enduring Annual Products will be released by means of application windows whilst the Daily and Off-Peak Daily products will be released through auction. In addition, implementation of UNC 195AV will remove charges foregone and interruption credits as part of exit reform. NGG proposes GCM05 as a way to address these changes.

The modification proposal

GCM05 proposes a consistent approach for the setting of actual, indicative and auction reserve prices for the NTS exit (flat) capacity products which were introduced by UNC modification 195AV; these prices would be determined on a nodal basis for all exit users. NGG will publish indicative prices more than one gas year in advance when offering Enduring and Enduring Annual capacity products through the application windows. The actual prices for the Enduring and Enduring Annual products will be published using the same methodology, but with updated input data, at the latest by 1 August in the gas year before the capacity is to be used.

The Transportation Model will be used to estimate Long Run Marginal Costs (LRMCs) for the provision of capacity, based on a single year network model. These LRMCs are then adjusted to determine indicative and actual Annual and Enduring Annual NTS exit (flat) capacity prices. We note exit LRMCs will continue

[1] The terms 'the Authority', 'Ofgem' and 'we' are used interchangeably in this document. Ofgem is the Office of the Gas and Electricity Markets Authority.
[2] This document also constitutes notice of the reasons for this decision as required by section 38A of the Gas Act 1986.

to be adjusted using an additive factor in deriving the exit capacity prices, as is currently the case. The additive factor was introduced with implementation of the Transportation Model in Charging Methodology modification proposal GCM01[3].

Reserve prices for the Daily NTS exit (flat) capacity auctions will be set based on the Enduring Annual/Annual NTS exit (flat) capacity charge which is in place for that gas day. The reserve price will be zero for Off-Peak Daily NTS exit (flat) interruptible capacity auctions. Note that these reserve prices are not indicative in nature, but are firm.

GCM05 specifies that the following specific inputs to the Transportation Model will be used in calculating NTS exit (flat) capacity prices:

- Network - the network model comprising the nodes and pipe lengths in the year of capacity release.
- Demand data - flow data based on baseline and incremental exit capacity levels, other than bi-directional system points (which are assumed to be in supply mode and hence will have a zero exit flow). Capacity data will be based on baseline quantities.
- Supply data – from NGG's Ten Year Statement (TYS).
- Supply and demand balancing – this is done using a merit order, whereby supplies are reduced until demand is matched in the following order; short range storage facilities (LNG), mid range storage facilities, long range storage facilties, interconnectors, LNG importation facilities and beach terminals.
- Expansion factor - calculated in gas year N-4 based on the costs of constructing NTS capacity for gas year N.
- Annuitisation factor – as per licence assumptions.

Charges foregone and interruptible credits will be removed from the Gas Transmission Transportation Charging Methodology as a result of GCM05.

An SO NTS exit (flat) commodity charge will replace the existing NTS SO exit commodity charge. A TO exit (flat) commodity charge will be introduced to offset under recovery arising from any shortfall between NTS exit (flat) capacity charges and TO exit allowed revenue, such that the net revenue recovery by NGG will remain unchanged. The NTS TO exit (flat) commodity charge will be identical in structure and application to the NTS SO exit (flat) commodity charge. Any exit over-recovery, though not greatly anticpated, will be dealt with through the separate K mechanism for exit.

Justification of the modification proposal

NGG states that, in its view, GCM05 better achieves the objectives of the gas transmission transportation charging methodology because it:

- is cost reflective – by generating prices through the Transportation Model based on a single year analysis the modification ensures users are paying for the network that is available in that year; by commoditising TO costs resulting from unsold baseline from all exit shippers GCM05 ensures that shippers utilising Off-Peak Daily capacity will attract a more appropriate level of TO costs; and by using the approach where LRMCs are adjusted using an additive factor the modification will be cost reflective by maintaining locational price differentials between exit points

[3] The LRMCs are adjusted to produce the exit capacity prices. The LRMCs for all exit points are increased by the same factor, the 'additive factor', which is calculated such that there are no negative exit capacity prices and that the revenue collected from these charges recovers the TO exit allowed revenue.

- facilitates effective competition - as users have access to the Transportation Model which allows them to replicate and forecast prices which should improve competition and reduce barriers to entry

Responses to NTS GCM05 consultation

NGG consulted on the proposals from January to February 2009. They received ten responses, nine of which supported the implementation of GCM05.

A number of respondents agreed that a consistent approach should be taken in setting actual, indicative and auction reserve prices for NTS exit (flat) capacity; and a number of respondents agreed that GCM05 achieved these aims.

There was also broad support for the use of the transportation model based on a single year network model, as this would allow NGG to make more precise and cost reflective price signals. Some respondents were concerned that a single year model may result in greater price volatility than observed using a model which relied on the ten year average.

There was support for calculating capacity charges on a nodal rather than a zonal basis as this should increase cost reflectivity.

Some respondents emphasised the importance of stability in prices between indicative and actual levels and between years. Another believed the use of baseline capacity to calculate the level of exit capacity charges should help make the charges more stable. Two respondents queried how GDNs would pass on the cost of the NTS exit capacity to their customers.

Respondents were supportive of setting the Off-Peak Daily NTS exit (flat) capacity auction reserve price at zero, as the cost of making this capacity available will already have been met.

Respondents agreed that the removal of interruption credits is consistent with implementation of UNC195AV.

There were mixed views on the creation of a new SO exit (flat) commodity charge and additional TO exit (flat) commodity charge. One respondent thought the proposals were compatible with existing arrangements and emphasised that over- and under-recovery mechanisms should be consistent and set at the same time (for transparency prior to bidding). This respondent considers this will provide greater certainty to shippers as to what they will receive/pay for over- and under-recoveries rather than if the over- and under-recovery mechanisms were determined after the auction. Respondents who disagreed with the creation of the TO exit (flat) commodity charge did so due to the timing of the proposal. Two were of the view that as TO exit under-recovery was unlikely to happen until 2012/13 there is little benefit to establishing a mechanism before then. They believed implementing a mechanism now prevents consideration of other measures that could be taken to smear back under-recovery to shippers. Another respondent thought that there was not enough understanding of the magnitude of the under-recovery that would occur and these changes should not be implemented until that is resolved. This respondent would prefer TO costs and allowed revenue to be recovered through capacity rather than non-cost reflective commodity charges.

The Authority's decision

The Authority has considered the issues raised by the modification proposal and the Conclusions Report dated 3 March 2009. The Authority has considered and taken into account the responses to NGG's consultation. The Authority has concluded that:

1. **Implementation of the modification proposal will better facilitate the achievement of the relevant objectives of the Methodology[4]; and;**
2. **Deciding not to veto the proposal is consistent with the Authority's principal objective and statutory duties.**

Reasons for the Authority's decision

SSC A5(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

GCM05 proposes to use baseline capacity as a basis for setting exit capacity charges. GCM05 should therefore improve cost reflectivity since the TO charges are levied to recover NGG's allowed revenue for use of the baseline capacity. However, if baselines are not sold-out then NGG will not recover its TO exit allowed revenue through these charges alone; it will require a further mechanism to recover its revenue.

We agree with respondents that at this point in time we do not know the level of capacity bookings, and therefore under- or over-recovery, for 2012/13. In spite of this we consider that a mechanism needs to be agreed now to provide certainty to NGG that it will be able to recover its costs fully.

The implementation of the TO exit (flat) commodity charge will allow NGG to recover its allowed revenue in the same year that any shortfall from the sales of capacity occurs. Its application should also mean that both firm and interruptible exit users pick up the shortfall between allowed TO revenue and capacity charges. This is more cost-reflective than the alternative treatments including an approach where "charges foregone" amounts are levied on either: firm users only, through higher capacity charges (which could artificially raise charges above capacity costs); or on both entry and exit users, by its recovery through the SO commodity charge (which would not adequately allocate costs to those incurring them). We therefore do not agree with the view that TO allowed revenues should be recovered solely by capacity and not commodity charges.

We agree with certain respondents that the use of a nodal rather than a zonal basis for calculating capacity charges should lead to an improvement in cost reflectivity. Nodal capacity pricing should produce more precise price levels than a system based on more general zonal areas.

SSCA5(aa) that, in so far as prices in respect of transportation arrangements are established by auction, either: (i) no reserve price is applied, or (ii) that reserve price is set at a level – (I) best calculated to promote efficiency and avoid undue preference in the supply of transportation services; and (II) best calculated to promote competition between gas suppliers and between gas shippers

Under the enduring offtake arrangements, Daily exit (flat) capacity is allocated by means of an auction with a reserve price. Setting a non-zero reserve price for

[4] As set out in Standard Special Condition A5(5) of NGG's Gas Transportation Licence

Daily exit (flat) capacity should mitigate the risk of market power that may be possible at exit points where there is only one user and so should promote competition between gas shippers. Additionally, we consider that setting the Daily exit (flat) capacity reserve price at the applicable Enduring Annual / Annual exit (flat) capacity charge should avoid undue preference in the supply of transportation services. This is because it would ensure that shippers purchasing exit (flat) capacity in the long term are not disadvantaged relative to those who secure Daily exit (flat) capacity in the short term.

Whilst we do not intend to veto the proposed approach, we would note that NGG adopts a different approach to setting daily reserve prices under the gas entry capacity auction framework. The approach taken for daily entry capacity is that there is a 33 per cent discount on the reserve price up to the day ahead and on the day the discount on the reserve price is 100 per cent i.e. a reserve price of zero. In light of this we consider that NGG should establish a principles-based approach to determining the level of reserve prices across the gas entry and gas exit auction frameworks. The GCM05 report does not, however, set out clear principles for determining reserve prices on a consistent basis across the two regimes. We believe there is merit in reviewing this aspect across both entry and exit once the impacts of developments such as entry capacity substitution on forward booking levels have been properly assessed.

The objectives of the charging methodology require charging either to be cost-reflective or, if done by auction, have a zero reserve price or one that is efficient, non-discriminatory and promotes competition. As the Off-Peak Daily exit (flat) interruptible capacity product is allocated by a zero reserve price auction then it meets the charging objectives.

SSC A5(5)(b) that, so far is consistent with sub-paragraph (a), the charging methodology properly takes account of developments in the transportation business

NGG have proposed GCM05 to align the charging methodology with the exit reforms, as implemented in UNC modification 195AV. UNC 195AV allowed for the release of NTS exit (flat) capacity to users via four different capacity products and requires the removal of charges foregone and interruptible credits. We agree with respondents that GCM05 consistently takes into account the developments in exit reform implemented through UNC195AV by levying appropriate charges for the four capacity products and removing both charges foregone and interruptible credits.

SSC A5(5)(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 use of the baselines for the demand data in the Transportation Model should allow shippers a more accessible method to calculate LRMCs than is currently the case with the use of forecast demand data. Using baselines published in NGG's gas transporter licence will allow users to conduct modelling themselves, allowing for more informed decisions. Such greater certainty in cost estimates can assist in facilitating new entry and remove barriers to entry, thereby furthering competition between shippers.

Decision notice

In accordance with Standard Special Condition A5 of NGG NTS's Gas Transportation Licence, the Authority has decided to not to veto modification proposal GCM05: NTS Exit (Flat) Capacity & Exit Reform.

Stuart Cook
Director, Transmission

Signed on behalf of the Authority and authorised for that purpose