Promoting choice and value for all gas and electricity customers

Modification proposal:	**Modification Proposal NTS GCM12 'Retrospective Negative TO Entry Commodity Charge & Separate Management of K'**		
Decision:	**The Authority[1] has decided not to veto this proposal[2]**		
Target audience:	**NGG NTS and other interested parties**		
Date of publication:	**19 December 2008**	Implementation Date:	**1 April 2009**

Background to the modification proposal

National Grid Gas National Transmission System (NGG NTS) recovers its Transportation Owner (TO) allowed revenue set under NGG NTS transmission price control (other than revenue collected through the distribution network pension charge and some metering charges) through exit and entry charges based on a 50/50 split of the total allowed revenue.

In the first instance, the allowed revenue from entry is recovered from sales of entry capacity through a series of auctions. If the revenue from these auctions is projected to fall below 50% of the TO allowed revenue, NGG NTS can recover the shortfall through the application of TO entry commodity charge. If revenue collected is in excess of the 50% of TO allowed revenue, several mechanisms are in place to redistribute that excess back to shippers. Initially, residual revenue is used during the year to offset entry capacity buy-back costs incurred which shippers pay to NGG NTS through capacity neutrality (GCM09[3]). If a surplus still remains after the application of the GCM09 mechanism, entry shippers can be rebated back a proportion of their TO entry commodity charge payments (GCM10[4]), limited to 100% of the TO entry commodity charge.

It is still possible after application of both of the above mechanisms that a residual over-recovery amount exists. NGG NTS developed another mechanism, GCM11[5], to resolve this issue. It proposed rebating the surplus to entry shippers as a retrospective negative TO entry commodity charge capped at the level of the SO entry commodity charge. The SO entry commodity charge is set at a level designed to recover 50% of the costs of the System Operator activities. These include incentives for SO entry (including buy-back), SO exit, SO external activities (including shrinkage) and SO internal activities.

The Authority vetoed GCM11 due to concerns including undue discrimination against exit users. The Authority was concerned that if there was a TO entry shortfall under GCM11, the shortfall would be recovered by both entry and exit users. In contrast, if there was a TO entry over-recovery, any benefit would pass through to entry users only.

The modification proposal ("the Proposal")

This proposes a retrospective negative TO entry commodity charge with separate "K" mechanisms for entry and exit, as NGG NTS considers this overcomes the

[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.
[3] GCM09 refers to the entry capacity buy-back offset mechanism, which was implemented on 1 November 2007
[4] GCM10 refers to the TO entry commodity rebate mechanism, which was implemented on 1 March 2008
[5] GCM11 refers to the retrospective negative TO entry commodity charge proposal which was rejected by the Authority

issues with GCM11. The “K” mechanism is the general mechanism used under the price control to deal with any revenue under- and over-recovery from year to year.

This proposal would introduce a mechanism where a residual TO over-recovery, following application of GCM09 and GCM10 would be credited back to shippers based on entry allocations which attract the TO entry commodity charge. The credits made through the GCM12 mechanism to shippers incurring TO entry commodity charges would be capped at the total SO commodity charges paid that year. This cap is employed so that the combined impact of SO and TO entry commodity charges does not represent a net credit to shippers; in the absence of the cap the mechanisms could result in perverse incentives for shippers to flow gas and get paid to do so.

For clarification purposes, only TO revenues are credited through the mechanism described in GCM12, whilst SO revenues are not credited. Furthermore, the application of the retrospective negative TO entry commodity charge in GCM12 does not apply to any TO exit over-recoveries.

The main characteristics of the proposed mechanism are:

- Any residual TO entry revenue remaining after accounting for the GCM09 and GCM10 mechanisms would be available as a credit to shippers
- Credits would only be paid based on relevant entry allocations i.e. those allocations that would attract the TO entry commodity charge
- Credits would only be paid if the residual over-recovery exceeded £1m (this equates to a minimum TO entry commodity price of -0.0001 p/kWh)
- Each shipper’s credit would be calculated as a proportion of the total available credits based on the ratio of that shipper’s SO entry commodity charges to the aggregate of all SO entry commodity charges paid over the formula year. For the avoidance of doubt, this calculation excludes optional (“short-haul”) entry commodity charges
- Credits would be paid following the end of the formula year
- The Licence defined “K” term would be split into separate entry and exit “K” components for the purposes of setting charges
- The applicable interest rate used to calculate “K” within the Licence depends on whether there has been over- or under-recovery

It is proposed to implement these arrangements with effect from 1 April 2009.

Justification of the modification proposal

NGG NTS considers that GCM12 better achieves the relevant gas transmission transportation charging methodology objectives in that it:

- Reduces the likelihood of over-recovery as the aggregate of all entry and exit charges would more closely reflect the costs incurred within and across the price control formula years
- Prevents cross subsidies between entry and exit users and hence should facilitate more effective competition between gas shippers and between gas suppliers through more stable and transparent charges
- Takes into account developments in the transportation business in anticipation of possibly more variable exit revenue resulting from exit reform and the impact of the enduring transfer and trade arrangements

Responses to NTS GCM 12

NGG NTS consulted on the proposals from July to September 2008 and received 11 responses. Eight respondents supported implementation of the modification, two supported the "K" management proposal with no comment on the mechanism, and one did not support implementation but supported the proposals for "K".

One respondent noted that under the current arrangements for the management of "K" there is an opportunity over multi-year periods for exit users to cross subsidise entry users, or vice versa. The respondent argued that this would not appear to be cost-reflective and would not be beneficial to competition. Targeting of "K" to entry and exit would ensure that the general principle of a 50:50 split of core revenue is maintained and so would remove the chances of a cross subsidy. Another respondent thought these proposals would avoid the problems of asymmetry and cross subsidisation inherent in GCM11. There was unanimity of support for the part of GCM12 which proposed to manage "K" separately for entry and exit.

There was concern over specific aspects of the rebate mechanism in particular the application of a retrospective charge. NGG NTS responded that the aim of the proposal is not to implement retrospective charges but retrospective rebates.

Another respondent was concerned that interest is not paid on over-recovery sums likely to be credited back under GCM12. This is in contrast to over-recovery sums that go into "K" which are subject to interest. NGG NTS responded that GCM12 would redistribute revenue at the end of the year and no interest would therefore apply, whilst "K" redistributes revenue in the following year and so interest would apply. NGG NTS also stated that there is no mechanism in the licence to allow for within formula year interest.

The Authority's decision

The Authority has considered the issues raised by the modification proposal and the Conclusions Report dated 21 November 2008. The Authority has considered and taken into account the responses to NGG NTS'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[6]; 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

Currently if there remains any TO entry over-recovery after application of the mechanisms in GCM09 and GCM10 then a "penalty" rate of interest is applied and this amount is then redistributed through the "K" mechanism evenly (on a 50:50

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

basis) between entry and exit users in the following formula period. The "penalty" interest rate is used in all price controls to provide companies with a strong incentive not to over- (under-) recover in any formula year. Ofgem considers that the application of the penalty rate is inappropriate in these circumstances as arguably it is much more difficult for NGG NTS to accurately forecast revenues from market based capacity arrangements such as auctions and transfer and trade and so it arguably has less control or influence over whether there is an over- or under-recovery than when it sets fixed charges for the year. Implementation of GCM12 should reduce the likelihood that residual over-recovery amounts remain to incur the penalty interest rate, which should better protect the interests of consumers.

Ofgem considers that GCM12 has the potential to improve the licensee's cost reflectivity by redistributing over-recovery amounts to the parties contributing to them and in the year in which they occurred.

Furthermore, the separate management of the "K" factor for entry and exit should ensure that entry and exit amounts are ring fenced and a 50:50 split of charging revenue is maintained. The proposal to split "K" into entry and exit components will further promote over-recovery amounts being returned to those users actually contributing to them.

Currently the NTS users that pick up the downside when there is a TO entry revenue shortfall are those users attracting the TO entry commodity charge. Ofgem considers that it would be equitable if these same users also benefit from the upside risk when there is an over-recovery. GCM12 would imply a symmetrical treatment of under- and over-recoveries.

Furthermore, capping credits at the level of the SO commodity charge ensures the combined impact of SO and TO entry commodity charges does not represent a net credit to shippers, as this could result in perverse signals for shippers to flow gas.

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

Ofgem agrees that the proposal takes into account developments in the transportation business and puts in place a mechanism to better deal with any resulting over-recoveries than the existing arrangements.

In 2007/8 a TO over recovery occurred, which arose as a result of the revenues from the Annual Monthly System Entry Capacity (AMSEC) and entry capacity transfer and trade auctions being greater than anticipated. This over-recovery resulted in the need to use the GCM10 TO entry commodity rebate mechanism. The introduction in 2008 of the transfer and trade mechanisms into the rolling monthly auctions resulted in pay-as-bid Rolling Monthly Transfer and Trade System Entry Capacity (RMTTSEC) auctions. This provides an additional source of entry capacity revenue each month. It is therefore possible that this could increase the potential for over-recoveries to occur. GCM12 better caters for these circumstances by providing an additional mechanism to distribute residual over-recovery amounts without incurring the penalty interest rate and flowing through the "K" mechanism.

For clarity, Ofgem notes that the proposals apply to over-recovery amounts only and there is no intention to have a similar mechanism for under-recovery. TO entry shortfalls will continue to be recovered through the application of TO entry commodity charges.

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

Currently if either auction revenues are below expectations or NGG NTS incorrectly under-forecasts the TO entry commodity charge levels, then there will be an under-recovery which feeds through to the following year's charges. Exit users are then exposed to 50% of what should be a relatively small shortfall amount. This risk is symmetric, in that if there is a TO entry over-recovery, after application of GCM9 and GCM10, then exit users will also benefit by a reduction in charges in the following year of 50% of the residual over-recovery.

GCM12 results in a similar symmetric treatment of entry and exit users in how over- and under-recoveries are treated. With GCM12 an entry over-recovery would be returned to entry users only whilst an entry shortfall is recovered from entry users only, and the same applies for exit over- and under-recoveries. Ofgem considers that the separate treatment of "K" for entry and exit reduces the risk of inappropriate risk being borne either by exit or entry users and transfers between entry and exit users and therefore should facilitate effective competition between gas shippers and gas suppliers.

Ofgem considers that by furthering the relevant objectives of cost-reflectivity, facilitating competition and accounting for developments in the transportation business, GCM12 should better protect the interests of consumers. Furthermore, implementation of GCM12 should reduce the likelihood of penalty interest rates being incurred on over-recoveries, which should also better protect the interests of consumers.

Way forward

We conclude that GCM12 furthers the relevant objectives of the charging methodology. However, our decision was finely-balanced. We consider that there is still potential for the methodology to be improved upon further. In particular, we have some remaining concerns about the current charging arrangements and the treatment of over- and under-recoveries which we highlight below.

- First, under certain circumstances, GCM12 might result in charges at entry that are below NGG NTS's short-run forward looking avoidable operating costs (such as the costs of operating compressors). If the risk of this is high then we would be concerned that it would create perverse pricing signals and incentives. NGG NTS would, at the margin, not be sending appropriate signals about the costs of transporting additional volumes of gas at certain locations.
- Second, we had concerns over whether entry and exit users are treated in an equitable way in dealing with the risks of revenue under/over-recovery. Exit users (and ultimately customers) appear to currently bear more of the downside risk associated with increasing the amount of entry capacity. For example, entry users only need to bid in the long term auctions sufficient volume to cover 50% of the net present value of the ***forecast*** costs of any capacity enhancements. This leaves risk with exit users once the capacity is constructed – particularly if outturn costs are much higher than forecast, therefore when the market price of capacity exceeds the cost of providing that same capacity it is arguable that part of the over-

recovery should be used to benefit consumers directly and immediately consistent with the risks they face.

- Finally we think it is worth considering whether other mechanisms for dealing with revenue over-recovery should be considered. The auction processes help to reveal the market value of capacity which may be above the cost of providing the capacity. This generates a surplus. Currently this surplus is returned directly to shippers at entry and exit through rebates. But there are alternatives for example accelerating the depreciation on NGG NTS's assets. NGG NTS's assets currently have assumed depreciation periods (c40 years). Given uncertainties over future levels of gas transportation demand given measures to tackle climate change it may be appropriate to shorten these asset lives when the market value of capacity exceeds the cost of providing it based on an assumed long asset life.

NGG NTS has an obligation to keep the charging methodology at all times under review. Given our concerns, we think it would be appropriate for NGG NTS to carry out a more holistic review of key aspects of the charging methodology next year, discuss them with shippers and consider whether further changes are appropriate.

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 GCM12: Retrospective Negative TO Entry Commodity Charge & Separate Management of K.

Stuart Cook
Director, Transmission

Signed on behalf of the Authority and authorised for that purpose