National Grid Gas NTS and other
interested parties

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Dear colleague,

Determining revenue drivers for entry and exit points: Canonbie and Gilwern

Ofgem[1] has recently consulted[2] on both National Grid Gas's (NGG's) modelling work to estimate costs of incremental capacity at the Canonbie entry point and the Gilwern exit point, and our approach to determining the revenue drivers for these points on the National Transmission System (NTS).

Having considered the responses to our consultation and having regard to the principal objective and statutory duties of the Authority[3], for the reasons set out in this letter the Authority is now proposing to set revenue drivers at Canonbie and Gilwern.

This letter outlines:

- the background to revenue drivers, including why these are now required at Canonbie and Gilwern;
- a summary of Ofgem's consultation proposals and the responses received to our consultation; and
- Ofgem's views and final proposal on the appropriate levels for these revenue drivers.

Background

Revenue drivers enable NGG's allowed revenue to automatically flex upwards in response to incremental capacity requests that are backed by financial commitment from users. They allow NGG to earn additional revenue for a fixed five year period[4]. Essentially, revenue drivers fund the depreciation and return on a deemed amount of capex, with an allowance for opex, over the five year period.

At the time of the Fourth Transmission Price Control Review (TPCR4), which covers the period 2007-2012, revenue drivers were determined for existing and anticipated entry points and for anticipated exit points.

[1] Ofgem is the Office of Gas and Electricity Markets Authority. The terms 'Ofgem' and 'the Authority' are used interchangeably in this letter.
[2] See 'Determining Revenue Drivers for Entry and Exit Points: Canonbie and Gilwern', 8 April 2009, on Ofgem website www.ofgem.gov.uk
[3] Set out in Section 4AA of the Gas Act 1986, as amended.
[4] At the price control following the end of the five year period investments are reviewed and the Regulated Asset Base adjusted appropriately to reflect any efficiently incurred investment.

Since completion of TPCR4, there has been a development which will result in gas entering onto the NTS at Canonbie; and a requirement for incremental exit capacity at Gilwern has also arisen. Ofgem has now been requested to provide revenue drivers so that NGG has greater certainty over its resulting revenues when allocating incremental entry and exit capacity at these NTS points.

The process undertaken for the determination of revenue drivers at Canonbie and Gilwern involved modelling work which was undertaken by NGG, consideration of the modelling work by Ofgem, an Ofgem consultation, and consideration of the issues raised by respondents to the consultation.

Consultation

Canonbie
In deriving the proposed revenue drivers for Canonbie we asked NGG to use a similar network modelling approach to that used for setting revenue drivers at TPCR4. NGG's modelling suggested that for an anticipated increment of below 25 GWh/day at Canonbie only multijunction modifications[5] are required.

In the case of Canonbie, Ofgem consulted on two main issues, these were:
(i) which cost assumptions to use for estimating the reinforcement costs; and
(ii) how to remunerate NGG for the cost of gas telemetry measuring equipment.

In relation to cost assumptions, Ofgem consulted on two options:
- **Option 1a** - use the TPCR4 unit cost assumptions; and
- **Option 1b** - use NGG's forecast of unit costs, which are higher than those in Option 1a (the cost of multijunction modifications are double the level implied by Option 1a).

In relation to the remuneration of the cost of gas telemetry measuring equipment, Ofgem also consulted on two options:
- **Option 2a** - include the cost with that of other reinforcement works for calculating the revenue drivers; and
- **Option 2b** - include the cost as a fixed item separate from and in addition to the revenue drivers.

Ofgem's provisionally preferred approach was to use cost assumptions implied by Option 1a and to remunerate NGG for gas telemetry measuring equipment as per Option 2a. This gave the revenue driver figures as set out in Table 1.

Table 1: Revenue drivers for entry point at Canonbie, £m/GWh/month

Delivery rate	0-25 GWh/day	25-100 GWh/day	100-500 GWh/day
Revenue Driver	0.0020	0.0038	0.0072

Gilwern
In deriving the proposed revenue driver at Gilwern NGG again used a similar modelling approach to that used during TPCR4. NGG's modelling concluded that the reinforcement work required for the lowest cost option is to uprate the pressure to operate the pipeline feeding the offtake.

Ofgem's provisionally preferred approach was to accept NGG's modelling and cost estimation and set a revenue driver at £1,304 per GWh/day per year.

[5] Multijunction modifications refers to situations where work is done to increase capability, through increased flow or greater flexibility, at an above ground installation where a number of pipelines converge. These can include replacement of site pipework and control valves to increase physical site capacity, uprating of existing pipework, replacement of metering equipment and installation of gas filtering equipment.

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Consultation responses

There were three responses to the consultation. A detailed summary of the responses is provided in Annex 1.

Canonbie
Two respondents supported Option 1a (using TPCR4 costs), while the other did not state its preference. All three supported Option 2a, ie remunerating NGG for gas telemetry measuring equipment through inclusion of their cost in the calculation of the revenue drivers.

One respondent noted that a principle which underpins the derivation of revenue drivers is cost reflectivity; the respondent argued that it is therefore appropriate to use up-to-date costs. However, the respondent noted that this may not be practical to do for each revenue driver and on balance supported using TPCR4 cost assumptions. Another respondent proposed using more up-to-date costs where justified.

In relation to the recovery of telemetry costs, one respondent considered it an issue that these costs – which are fixed in nature - would be remunerated via per GWh/day revenue drivers. However, the respondent accepted that other fixed cost items are currently included in the revenue driver calculation and considered it would not be appropriate to have a separate licence item for gas telemetry measuring equipment. Another respondent did not think that NGG had made justification for remunerating gas telemetry measuring equipment through a separate fixed cost item; it also noted that such an approach increases complexity and is contrary to how other 'lumpy' investments are remunerated through the revenue driver. The remaining respondent was concerned that gas telemetry measuring equipment was omitted from calculating the revenue drivers at new entry points in TPCR4 and questioned whether any other material cost items were omitted.

Gilwern
The only respondent offering views on our proposed approach, supported inclusion of an annual revenue driver of £1,304 per GWh/day for incremental exit capacity at Gilwern.

Ofgem's view

Canonbie
Ofgem is minded to use TPCR4 cost assumptions as no compelling evidence has been provided to suggest moving away from these cost assumptions. This approach will speed up the process of agreeing revenue drivers while ensuring that future assessments of cost efficiency are informed by the detailed considerations that took place at the time of the last price control as well as by the specialised resources available at the time of price controls.

Having taken account for the views of respondents Ofgem remains of the view that gas telemetry measuring equipment should be remunerated through inclusion of their costs in the revenue driver. This is consistent with how comparable investments are currently remunerated and does not lead to increased complexity in revenue calculations in the licence. It also protects consumers through balancing the risks between NGG and consumers. NGG faces a potential gain in the case of larger projects if it can deliver incremental capacity at costs lower than the revenue driver (eg through economy of scale effects). This would be to the disadvantage of consumers. However, consumers can be protected by balancing this potential loss with the potential gain they face from small incremental projects for which NGG's cost of providing the fixed cost items may be more than it receives from the revenue drivers.

Ofgem remains of the view that it is appropriate to use TPCR4 cost assumptions and to remunerate gas telemetry measuring equipment by including their costs in the revenue drivers. Therefore, Ofgem intends to set revenue drivers for Canonbie as per the figures in Table 1.

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In answer to a question raised by one of the respondents, Ofgem is not aware of any other material cost item being omitted from the calculation of revenue drivers at TPCR4.

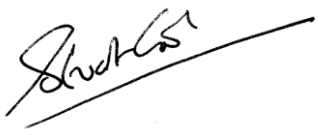
Gilwern
Ofgem still supports an annual revenue driver of £1,304 per GWh/day for incremental exit capacity at Gilwern. This is based on the lowest cost option for delivering 20.215 GWh/day of incremental capacity at Gilwern.

Decision

Following consideration of the modelling work done by NGG and the consultation responses, and having regard to the Authority's principal objective and statutory duties, the Authority proposes setting revenue drivers for Canonbie as per the figures in Table 1 above and for Gilwern of £1,304 per GWh/day.

Accompanying this decision letter is a Section 23 Gas Act 1986 notice setting out the proposed modifications to NGG's gas transporter licence to implement this decision. Subject to any representations and National Grid Gas's consent, Ofgem aims to modify the licence condition on 29 June 2009.

Yours sincerely,



Stuart Cook
Director, Transmission
Signed on behalf of the Authority and authorised for that purpose.

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Annex 1: Consultation Responses

Modelling

Do you agree with the modelling assumptions we instructed National Grid Gas (NGG) to use?

One respondent agreed with the modelling assumptions.

Do you agree with the modelling approach used by NGG and its modelling output for the entry point at Canonbie?

One respondent agreed with the modelling approach but was unable to comment on absolute values as they were not published.

Do you agree with the modelling approach used for the exit point at Gilwern?

One respondent agreed with the modelling approach.

Do you agree with our view that the modelling undertaken meets our request?

One respondent agreed that the modelling undertaken met the request.

Are there any other issues we should have considered in the modelling approaches outlined in this chapter? Plus any other comments.

One respondent thought it was appropriate to adopt the same principles to set the proposed revenue drivers as was used to set existing revenue drivers. Another believed that all issues were considered in the modelling approaches.

Cost estimation

Do you agree with our provisionally preferred option regarding costs assumptions ie Option 1a which uses the unit cost assumptions as employed at TPCR4?

One respondent agreed with the provisionally preferred option, though it was concerned that NGG has indicated that significant changes have taken place to the costs assumptions made at TPCR4 without producing sufficient evidence.

Another respondent thought that a principle of setting revenue drivers is to reflect the costs of investing and so it was appropriate to use the most up-to-date cost data. However, this respondent noted the practical implications of doing this for each revenue driver and on balance supported the use of TPCR4 cost assumptions unless for a large project where TPCR4 assumptions were significantly misaligned.

The other respondent considered that it was appropriate to use more up-to-date cost data where available as long as it could be justified.

Do you agree with our provisionally preferred option regarding the remuneration of gas telemetry measuring equipment ie Option 2a to include it along with other reinforcement work when calculating the revenue driver?

One respondent noted that entry revenue drivers are calculated on a per GWh basis despite some of the investment being fixed cost as is the case for gas telemetry measuring equipment. As other fixed cost items have been included in the calculation of revenue drivers it considered that it may not be appropriate to have a separate approach for gas telemetry measuring equipment and so supported Option 2a. However, it considered that

separating fixed and variable cost items when setting revenue drivers merits consideration at the next TPCR.

The other two respondents also agreed with Option 2a. One argued that there is no justification given by NGG for remunerating gas telemetry measuring equipment through a separate fixed cost item. It considered that such an approach would increase complexity of the arrangements and other 'lumpy' investments have been included in the calculation of revenue drivers. The other was concerned that gas telemetry measuring equipment was omitted in the calculation of revenue drivers at new entry points at TPCR4 and wanted to know whether any other material cost item was omitted.

Do you agree with our preferred approach of including a revenue driver of £1,304 per GWh/day per year for incremental capacity at Gilwern in NGG's gas transporter licence?

The two respondents to this question supported Ofgem's approach.

Are there any other considerations which we have not highlighted which we should have taken into account? Plus any other comments.

Two respondents supported the proposal for a generic revenue driver methodology.

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