Promoting choice and value for all gas and electricity customers

Modification proposal:	**Modification Proposal NTS GCM17 'QSEC New ASEP NTS Entry Capacity P0 Pricing'**		
Decision:	**The Authority[1] has decided not to veto this proposal[2]**		
Target audience:	**NGG NTS and other interested parties**		
Date of publication:	**23 June 2009**	Implementation Date:	**1 July 2009**

Background to the modification proposal

The Quarterly System Entry Capacity (QSEC) auctions allocate gas entry capacity in quarterly blocks between 2 and 16 capacity years[3] in advance. For existing entry points the QSEC auction allocates previously unsold capacity and allows for the triggering of incremental capacity in addition to the existing obligated level. For new entry points, where the obligated level is currently zero, the QSEC auction provides an opportunity to signal the requirement for incremental capacity at those points.

At the QSEC auctions shippers bid for capacity amounts at various price steps at a particular entry point and quarterly period. The minimum price that shippers are required to bid at is the reserve price. The reserve price is currently set in the following way depending on whether the entry point is existing or new:

- Existing – set at the annuitised Long Run Marginal Cost (LRMC) using the transportation model (subject to 0.0001 p/kWh/day collar for entry points with negative LRMCs)
- New – set at zero

For incremental entry capacity to be triggered the value of the bids received over an eight year period, starting when the capacity would be contractually delivered, must be equal to or greater than 50 per cent of the Net Present Value (NPV) of the estimated project value.

The allocation rules for QSEC auctions are such that if aggregate entry capacity bids at the reserve price are less than or equal to the available amount of capacity then NGG allocates entry capacity to shippers, and shippers pay the reserve price.

If a shipper (or a combination of shippers) bids such that its combination of price and quantity in the quarters in the relevant eight years passes the NPV test, incremental capacity will be released and is therefore available in all periods from 42 months out (the default lead time for provision of new capacity) to 16 capacity years. At the same QSEC auction the shipper can bid for capacity in quarters other than those contributing to passing the NPV test. If it bids for capacity equal to or less than the available amount (i.e. the incremental amount signalled by the NPV test) in these quarters the capacity will be allocated at the reserve price. In the case of new entry points this capacity is therefore allocated at a zero price.

There are concerns that having different reserve prices is discriminatory between new and existing entry points and creates a perverse incentive that users may

---

[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] The Capacity Year definition was recently changed as a result of the approval of Uniform Network Code (UNC) modification UNC230AV and now runs from 1 October to 30 September in the following calendar year.

elect to have a new entry point very close to an existing one so that they can pick up some of the capacity there for free.

The modification proposal

The modification proposal states that for new entry points the reserve price will be calculated consistently with the methodology used for existing entry points. This means that the reserve price for new entry points will be:

- Set at the annuitised LRMC using the transportation model
- Constrained at 0.0001 p/kWh/day for entry points with negative LRMCs

Justification of the modification proposal

National Grid Gas (NGG) considers that GCM17 better achieves the relevant gas transmission transportation charging methodology objectives in that it:

- reflects costs – as commodity charges can be set in a more cost reflective manner,
- promotes efficiency and avoids undue preference via the reserve price – as it removes the perverse incentive to create a new entry point near an existing point and has consistent treatment of new and existing entry points in terms of reserve price setting,
- facilitates competition – as it prevents cross subsidy between users at different entry points and between entry and exit users as without the implementation of GCM17 exit users could face higher System Operator (SO) commodity charges.

Responses to NTS GCM 17 Consultation

NGG consulted on the modification proposal between 17 April 2009 and 15 May 2009. They received five responses, four of which supported the proposal whilst one offered qualified support.

One respondent noted that it was inappropriate to set the reserve price at zero for new entry points such that long-term capacity could be acquired there for free in the first QSEC auction when the long-term capacity would be bought at a non-zero price at other times.

One respondent noted that as a result of some capacity being picked up for free then a larger amount of allowed revenue that NGG receives from the incremental signal could, in theory, be recovered through higher Transmission Owner (TO) and System Operator (SO) commodity charges.

Another respondent thought it was consistent for the reserve price to be calculated in the same way for new and existing entry points.

One respondent offered qualified support on the basis that the NPV test is reviewed and that the lack of cost reflectivity for pricing at entry points with negative LRMCs is addressed. This respondent thought that where incremental capacity is triggered without investment being made that a cross subsidy flows from users at the new entry point to those at existing entry points. Another concern was that the benefits provided by entry points with negative LRMCs are not reflected in the charges.

Three respondents agreed that the proposal should be implemented on 1 July 2009.

The Authority's decision

The Authority has considered the issues raised by the modification proposal and the Conclusions Report dated 26 May 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

Ofgem considers that removing arrangements that allow some long-term entry capacity to be picked up for free at new entry points should help to ensure that costs are better targeted on those parties responsible for causing them (namely those parties triggering incremental investment). This should also mean that National Grid avoids having to recover any revenue shortfalls (associated with zero price sales of incremental capacity) from users through TO and SO commodity charges. In turn, this should also help National Grid to set commodity charges at levels that are more reflective.

SSC A5(5)(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 gas transmission services; and (II) best calculated to promote competition between gas suppliers and between gas shippers

We agree with the respondents that noted that GCM17 will set reserve entry capacity prices consistently for new and existing entry points such that they are calculated on the basis of the annuitised LRMCs from the transportation model (subject to a collar of 0.0001 p/kWh for entry points with negative LRMCs). We consider that this will remove the ability for shippers at new entry points to acquire some long term capacity for free under the current arrangements. It will also remove the perverse incentive that users have to request a new entry point near to an existing entry point in order to gain from the loop-hole. GCM17 will promote efficiency through the removal of this perverse incentive.

As noted above GCM17 will result in greater amounts of NGG's allowed revenue being recovered through entry capacity charges at the new entry point where incremental capacity has been released. We agree with the respondent that this reduces the cross subsidy inherent in the current arrangements whereby the shipper picks up some long-term entry capacity at new entry points for free but with NGG recovering any short fall in revenues through either SO commodity charges from other entry and exit users or TO commodity charges from other entry users.

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

The respondent offering qualified support noted that the proposed capacity charges are not reflective of the benefits to the NTS from entry points with negative LRMCs due to these charges being capped. The charging methodology objectives for capacity prices which are set by auction requires either there to be no reserve price or for it to promote efficiency and avoid undue preference. If capacity charges were negative at entry points where the LRMC is negative then this may provide a perverse incentive for shippers to buy capacity there in order to be paid when there is no guarantee that they would flow – since it is the actual flow of gas at these points which can provide benefits.

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

GCM17 will result in greater amounts of NGG's allowed revenue being recovered from sales of incremental capacity and not through the TO and SO commodity charges. As the commodity charges are the same level for all users this is not an area in which they can compete. Therefore reducing the amount of allowed revenue recovered through the commodity charges should facilitate greater competition.

As mentioned above, Ofgem considers that GCM17 will remove potential cross subsidies between different users and allow for better targeting of costs towards the parties responsible for creating them. Therefore, this should help NGG avoid undue preference in the supply of transportation services and promote competition between gas Shippers and gas suppliers.

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 GCM17: QSEC New ASEP NTS Entry Capacity P0 Pricing.

Stuart Cook
Director, Transmission

Signed on behalf of the Authority and authorised for that purpose