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Our Reference NTS GCM 19 RIA 77/10

Dear Richard,

77/10 Impact Assessment “Review of NTS entry charge setting arrangements”

Thank you for the opportunity to respond to the above Ofgem impact assessment.

National Grid NTS does not support the conclusions of the impact assessment and continues to believe that the implementation of GCM19, UNC0284 and UNC0285 would have a positive impact in regard to reducing the potential for cross subsidies, consistency with investment signals, and consistency with EU Regulation 715/2009 which comes into force from March 2011.

More detailed responses to the questions laid out in the Impact Assessment consultation document are included in the accompanying Appendix.

Please do not hesitate to contact me if you wish to further discuss any aspect of this response or more general aspects associated with the NTS Charging Methodology.

Yours sincerely,

Steve Fisher
Gas Charging and Access Development Manager

CC Paul O'Donovan; Richard Miller; James Thompson

Appendix - Detailed Response

CHAPTER: Three

Question 1: Do you agree with NGG's analysis on the impacts of removing the reserve price discounts?

National Grid NTS continues to believe that the analysis¹ represents a reasonable estimate of the impact the proposal would have had in 2008/9. One of the benefits of the proposal was identified as limiting increases in the TO entry commodity charge. Updated analysis suggests that the minimum impact of the change in 2009/10 would have been £11m compared to £3m in 2008/9. This suggests an increasing reliance on short term entry capacity and that the proposal would indeed limit the increasing TO Entry Commodity charge and hence limit the potential for cross subsidies.

CHAPTER: Four

Question 1: Do you agree with our analysis of the proposals against the appropriate objectives?

National Grid NTS agrees that the proposals have been assessed against the relevant objectives but is concerned that assessment against the EU regulations seems to infer that auction arrangements override the other EU requirements particularly in regard to cost reflectivity and avoiding cross subsidies.

Question 2: Do you agree with our provisionally preferred approach which would be to not implement any proposal to reallocate the revenues from baselines?

National Grid NTS does not support Ofgem's preferred approach.

If NTS Entry Capacity auction reserve prices are not set on a cost reflective basis, through the application of discounts and selling interruptible entry capacity while firm remains available, the costs not collected through the auction process will be collected through the TO Entry Commodity Charge. This raises the issue that if prices established through auctions are not cost reflective then the TO Entry Commodity Charge may not be cost reflective.

Removal of discounts, in combination with the application of the Gas Charging Transportation Model (as introduced by NTS GCM 01), would mean that the costs incurred in making transportation capacity available at an ASEP would be recovered through NTS Entry Capacity charges levied on entry capacity holders at the relevant ASEPs. TO Entry Commodity Charges could be reduced and hence charges overall would be more cost reflective.

Promoting Efficiency: Investment Signals

National Grid NTS believes that the current discounts for short term NTS Entry Capacity at existing entry points disincentivise Users to procure entry capacity in the longer term auctions. Constrained periods may have been avoided if there had been a greater incentive to book long term entry capacity. If the prevailing Entry charging arrangements remains, there is a risk that a constraint might become material at another ASEP.

¹ The analysis, carried out to quantify the minimum impact of the proposed changes, was based on an assumption that shippers would procure only sufficient firm daily entry capacity to meet gas flow allocations in excess of monthly entry capacity holdings and that shippers would trade any spare entry capacity held.

Promoting Efficiency: Stability

Discussions with the industry have indicated that stable, or at least predictable, prices are preferable. National Grid NTS is concerned that the industry desire for stable and predictable prices is not fulfilled by discounting entry capacity prices in the short term. National Grid NTS believes that commodity uncertainty may be factored into longer term gas contracts and that this uncertainty may result in higher prices for end consumers.

Avoiding Undue Preference: Potential Cross Subsidies

Shippers have an incentive to 'wait and see' due to entry capacity price discounts on day ahead (33%) and within-day (100%) auctions. Any shortfall in the recovery of revenues by National Grid NTS through entry charges is picked up through the TO Entry Commodity Charge paid by all shippers. This means that short term entry capacity buyers are having their entry capacity related costs paid by shippers who have previously paid the longer term rate for entry capacity.

This creates;

- cross subsidies between shippers who buy long term rather than short term and between entry points,
- cross subsidies between shippers who buy firm rather than interruptible,
- interruptible entry capacity that is effectively firm if firm entry capacity remains unsold,
- potential undue discrimination for new ASEPs which have no access to zero priced entry capacity as there are no short term auctions prior to passing the economic test through the long term entry capacity auctions

New entry points may be at a disadvantage in that no short term discounted entry capacity is available prior to incremental entry capacity being released through a long term QSEC auction. Effectively new participants who are not immediately able to benefit from the entry discounts may, through the TO Entry Commodity Charge, be cross-subsidising existing participants.

The TO Entry Commodity Charge was designed as a correction mechanism for under-recovery of allowed revenue from auctions. Using this charge to collect a large amount of under-recovered income from entry capacity auctions will result in a redistribution of charges from Users acquiring entry capacity at a discounted rate to those Users that have previously paid a "full" rate for entry capacity.

Promoting Competition: Secondary Market

Reserve price discounts may be a factor that inhibits entry capacity trading at ASEPs when there is unsold Obligated NTS Entry capacity. Some Users may have surplus entry capacity holdings and others are seeking short term rights but the value of sold entry capacity is destroyed by the existence of zero priced entry capacity.

Users with surplus entry capacity holdings purchased in long term auctions are inhibited from trading away their surplus due to the substantially discounted primary entry capacity made available to other Users. Removal of discounts should promote the secondary market in entry capacity.

Competition

The use of long run marginal cost (LRMC) based prices should ensure that, in the absence of effective competition at an entry point, locational prices avoid undue preference. Discounts that set a zero reserve price can affect locational signals in short term auctions and allow Users at non-competitive entry points to purchase entry capacity cheaply, passing on costs of providing entry capacity at these entry points to other system Users, through potential buy-back costs and TO Entry Commodity Charges.

Removal of the discounts should help to avoid cross subsidies and potential constraints resulting from missed investment signals which should promote competition within the wider gas supply market.

CHAPTER: Five

Question 1: Do you agree with our analysis of each of the options against the measures we consider?

National Grid NTS agrees with Ofgem's analysis of the options in that the combined impact of GCM19 and UNC0285 has the greatest impact, and changes to the allocation of within day revenues (option 3) might only have a marginal further benefit in addition to the two main proposals.

CHAPTER: Six

Question 1: Do you agree with our analysis on the impacts of the options on existing and future consumers being their interests as a whole in terms of both security of supply and reduction of greenhouse gases?

While acknowledging the potential short term security of supply benefits of the prevailing arrangements, on balance National Grid NTS does not agree with Ofgem's analysis in regard to consumers and security of supply. The proposals are a first and necessary step towards creating a regime where the risk of avoiding delayed investment signals and disincentives for cross border trade are minimised, hence improving security of supply. The proposals should create more predictable long term charges which might reduce the probability of a premium to cover variable commodity charges being passed on to end consumers. While there is some uncertainty about the initial magnitude of the impact of the proposals, National Grid NTS believes that implementation could only put a downward pressure on commodity prices.

Question 2: Do you agree with our analysis on the impacts on health and safety?

National Grid NTS agrees with Ofgem's analysis on health and safety.

Question 3: Do you agree with the risks and unintended consequences we have identified?

National Grid NTS agrees with Ofgem's view that it is unlikely that the proposals will lead to the withholding of available entry capacity at times of high system demand. Placing a consistent reserve price on day-ahead and within-day entry capacity should increase the likelihood that entry capacity is requested ahead of the day and hence should increase the likelihood that available entry capacity can be made available. National Grid NTS believes that there may be an increased risk of system by-pass if the proposals are not implemented and this is covered later in this response.

Question 4: Are there any other impacts we should have addressed?

When the clearing obligation and zero reserve price were first introduced concerns were raised that this could lead to capacity revenue under recovery and, Ofgem included the following comments covering this issue in its decision;

“Ofgem would note that in setting zero reserve prices for within-day sales, Transco will still be subject to its Licence obligation to avoid undue preference in the supply of transportation services.

Ofgem notes that some respondents have raised concerns regarding the potential impact of this proposal on Transco’s revenue. Ofgem however considers that there is sufficient competition for entry capacity at the majority of beach terminals in the short term auctions to guard against any significant revenue under-recovery.”

As sufficient competition appeared to be an issue when introducing these arrangements, an assessment of competition may inform the decision. An assessment of competition was included in the Entry Charging Review Group (ECRG) process and was presented on at the ECRG on 9th September 2009 which indicated limited competition.

The use of LRMC based prices should ensure that, in the absence of effective competition at an entry point, locational prices avoid undue preference. Discounts that set a zero reserve price can affect locational signals in short term auctions and allow Users at non-competitive entry points to purchase entry capacity cheaply, passing on costs of providing entry capacity at these entry points to other system Users, through potential buy-back costs and TO Entry Commodity Charges.

Removal of the discounts should help to avoid cross subsidies and the constraints resulting from missed investment signals which should promote competition within the wider gas supply market.

CHAPTER: Seven

Question 1: Do you agree with our conclusions?

National Grid NTS does not support Ofgem’s conclusions. National Grid NTS continues to believe that the large quantities of zero reserve priced NTS Entry Capacity create cross subsidies between long term and short term users and between users at different entry points. It is National Grid NTS’s view that this is not consistent with promoting competition and is not consistent with the EU regulations.

Regulation (EC) No 715/2009 Article 13 states that “Tariffs, or the methodologies used to calculate them, shall facilitate efficient gas trade and competition, while at the same time avoiding cross-subsidies between network users and providing incentives for investment and maintaining or creating interoperability for transmission networks.” This requirement is in addition to the statement that “Member States may decide that tariffs may also be determined through market-based arrangements, such as auctions,” and National Grid NTS believes that the implication is that auctions are not an alternative to meeting the other obligations, particularly the obligation relating to the avoidance of cross subsidies.

National Grid NTS remains to be convinced that there are low value users of the system who would be disadvantaged by the removal of the zero prices as NTS Entry charges can be passed on at the NBP. National Grid NTS does not believe that shippers bid their value of entry capacity but simply seek to minimise their costs in the light of available information such as that provided through the Ten Year Statement and the Licence obligations in regard to the provision of obligated entry capacity levels. National Grid NTS also notes that those Users that book capacity in the short term auctions in relation to storage sites are not contributing to the system operating costs through the commodity charge.

Question 2: Are there any other issues that need to be raised to inform the Authority's decisions on these proposals?

The two main and interrelated further issues that National Grid NTS believes should most strongly inform the decision are consistency with Regulation (EC) No 715/2009, which comes into force from September 2011, and how potential cross subsidies might lead to incentives to by-pass the system.

Regulation (EC) No 715/2009

Regulation (EC) No 715/2009 Article 13 section 2 states that “Tariffs for network access shall neither restrict market liquidity nor distort trade across borders of different transmission systems. Where differences in tariff structures or balancing mechanisms would hamper trade across transmission systems, and notwithstanding Article 41(6) of Directive 2009/73/EC, transmission system operators shall, in close cooperation with the relevant national authorities, actively pursue convergence of tariff structures and charging principles, including in relation to balancing.”

Throughout the entry charging review National Grid NTS has highlighted that the significant quantities of zero reserve priced entry capacity released within the GB regime are not consistent with other European nations. In response to our consultations it has been suggested that the high TO Entry Commodity charge which is a function of the quantities of zero reserve priced entry capacity hampers trade across the interconnectors and hence across transmission systems. National Grid NTS believes that implementing GCM19 and UNC0284 & UNC0285 would represent “increased convergence of tariff structures and charging principles”, as required under EU regulations, without introducing a premium for short term compared to long term entry capacity, as has been highlighted as a potential issue with some European charging regimes.

Regulation (EC) No 715/2009 Article 13 states that tariffs shall reflect the actual efficient costs incurred and avoid cross-subsidies between network users. While the section states that “Member States may decide that tariffs may also be determined through market-based arrangements, such as auctions”, it should be noted that this is qualified by “also” and not “instead of” in relation to the requirement to reflect costs incurred and avoid cross subsidies.

Regulation (EC) No 715/2009 Article 13 states that tariffs shall be set separately for every entry point into or exit point out of the transmission system; this would not appear to be the case for the within day entry reserve prices.

Regulation (EC) No 715/2009 Article 14 states “the price of interruptible capacity shall reflect the probability of interruption”. National Grid NTS’s interpretation is that when there is a very low probability of interruption the interruptible price should be close to the firm price and when there is a very high chance of interruption (which might be the case when firm has sold out or is close to selling out) the price should be close to zero. National Grid NTS believes that the UNC0285 proposal is more consistent with this requirement by maintaining the zero reserve price for interruptible entry capacity but only releasing when firm capacity is 90% sold out and hence there is a greater likelihood of interruption.

Leaving aside the issue that no investment costs have been incurred in making interruptible entry capacity available, National Grid NTS believes that the UNC0285 proposal is more consistent with the intent of the EU regulations. Regulation (EC) No 715/2009 Article 16 states that unused entry capacity should be released “in the event of contractual congestion” i.e. when firm entry capacity is close to selling out. The prevailing arrangements result in zero prices when there is little risk of interruption (firm remains unsold) and high prices (due to competition) when firm has sold out and the risk of interruption is higher.

Costing Approaches & Potential System By-Pass

As the impact assessment conclusions are based on the concept of short duration entry capacity being priced on a short run marginal cost (SRMC) basis, the relevant benefits of short run, long run and average pricing concepts need to be considered.

Long run marginal costing (LRMC) involves considering investment costs, raw materials and operational costs whereas short run marginal costing involves considering raw materials and operational costs only and does not consider investment costs.

When considering the provision of NTS entry capacity we need to consider what investment, material and operational costs are incurred. NTS entry capacity is a commercial product to facilitate the gas market and does not have an exact mapping to a physical product; however, transportation capacity (pipes, compressors and associated installations) provide entry and exit capacity and these investment costs can be mapped onto entry and exit capacity.

In providing entry capacity there are clearly investment costs associated with the provision and replacement of assets and these costs are funded through the TO price control. The operational costs associated with the provision of entry capacity are small, largely associated with the operation of the commercial regime and are met through the SO price control. Most operational costs are incurred through the utilisation of entry capacity and these costs are met through the SO control and specifically through the SO commodity charge. As Entry capacity is a transportation service, rather than a material product, there are no associated raw material costs. When we consider all the costs involved it can be seen that the TO SRMC is zero as there are no TO material or TO operational marginal costs associated with providing the entry capacity service.

As the TO control is essentially funding the provision of transportation capacity through NTS assets (pipes, compressors and associated installations) and these costs are all investment and maintenance costs, these costs need to be recovered through a combination of charges that reflect these costs such as long run marginal cost (LRMC) based prices. SRMC based pricing in isolation would recover no revenue.

Average Costing

Analysis carried out as part of the Entry Charging Review has indicated that if the level of entry capacity forecast as being required through the 2008 Ten Year Statement forecast of peak supplies were procured for 365 days per year at QSEC prices, the collected revenue would approximate to the target revenue. This indicates that the LRMCs, which underpin the entry capacity reserve prices, are a good estimate of the average costs of entry capacity.

Cross Subsidies

If LRMCs and hence QSEC prices reflect the average cost of providing entry capacity and SRMCs are less than the average cost (and as TO SRMCs are zero they must be) then the average cost of procuring capacity at SRMC based prices must be met through other charges and these costs are currently met through the TO Entry Commodity charge. It is the application of a high rate TO Entry Commodity charge which can result in cross subsidies.

Implications of the prevailing Charging Regime

As shippers gain more experience of the NTS charging and access arrangements their strategies for minimising entry capacity costs improve. Two of the key drivers for under recovery identified through the Entry Charging Review (ECR) process were the prices paid for entry capacity and shippers ability to profile entry capacity procurement to meet flows. The more accurately shippers can profile their entry capacity procurement to meet flows and the greater their utilisation of discounted firm and interruptible entry capacity products the lower the TO Entry Capacity Revenue and the higher the TO Entry Commodity charge.

High commoditisation leads to a flattening of charges such that prices are effectively postalised. Shippers that are more successful at optimising their charges are cross subsidised by those that are not and this is a true cross subsidy as those shippers that minimise their entry capacity costs are not creating any cost savings for the rest of the industry.

Cost Reflective Charging

Long run cost reflective charging for transmission capacity is important for two reasons. The first is that it should result in charges paid by shippers meeting the costs incurred by the Transportation System Owner (TO) in providing incremental capacity. This is not an issue when incremental entry capacity is not or cannot be released and hence it might be thought appropriate to disregard LRMC based pricing for anything other than long term procurement of entry capacity. To see if ignoring LRMC based pricing for short term auctions is appropriate we must consider the second reason for LRMC based pricing.

The second reason for LRMC based pricing is to ensure all shippers, in procuring capacity, face no more than the investment costs of the capacity utilised such that inefficient by-pass of the system is avoided.

- If a shipper is faced with transportation costs (capacity and commodity) that are equal to or lower than the alternative cost of building pipe between entry and exit points (the LRMC), use of the transportation system is economic for the shipper.
- If a shipper is faced with transportation costs (capacity and commodity) that are higher than the alternative cost of building pipe between entry and exit points (the LRMC), use of the transportation system is not economic for the shipper and they may build their own pipeline.

In this instance by-pass of the system is not economic and efficient for the industry as a whole as remaining shippers face higher costs and the transportation system is underutilised; spare capacity on the primary transportation system is replicated by the shipper as a result of inappropriate price signals.

Short-haul

The NTS optional commodity charge (or short-haul charge as it is more popularly known) was introduced to avoid inefficient by-pass of the system i.e. to avoid the situation where price signals might trigger the inappropriate replication of system spare capacity. When shipping gas over short distances the standard (postalised) commodity charge may be more than the LRMC for the shipper of constructing its own transportation capacity.

The optional commodity charge is an SO charge which replaces both the entry (TO & SO) and exit (SO) NTS Commodity Charges for a quantity of gas representing the lesser of the flow allocated out at the nominated exit point and the flow allocated in at the nominated entry point.

If Entry Commodity charges increase as a consequence of the zero (SRMC) reserve priced entry capacity uptake, the option of utilising the optional commodity charge becomes more attractive.

As the optional SO commodity charge is a defined rate (independent of allowed revenue and auction outcomes) the standard SO commodity charge is calculated to recover the remaining SO allowed revenue, having first deducted short-haul revenue (and other specific SO charges), from all non-storage entry and exit allocations other than those that attract the short-haul rate. The TO Entry Commodity charge is calculated to recover all TO Entry revenues not recovered through entry capacity charges from all non-storage entry allocations other than those that attract the short-haul rate.

The upshot of these arrangements is that as the standard commodity charge rates increase, the more attractive the short haul rates become and the more flows that convert to short-haul. As more flows convert to short-haul the higher the standard commodity charge becomes for those utilising the NTS and the higher the standard commodity rate becomes, the more attractive the short-haul rate becomes, creating a cycle of increasing costs. Is there any evidence to suggest that this is happening? Clearly there is evidence that the TO entry commodity rate is increasing and that there is potentially greater reliance on discounted short term entry capacity. National Grid NTS is receiving a higher number of enquiries regarding short-haul.

Commoditisation Solutions

The simplest and cheapest² way of overcoming the problem is to reduce the commodity rate and that is precisely the objective of the Entry Charging Review and a key driver underlying the proposal to remove the entry capacity discounts and limit interruptible entry capacity release; but are there any alternatives?

There may be natural breaks to high commoditisation. When a constraint at an ASEP becomes acute, significant competition for NTS Entry Capacity may be a consequence leading to realisation of shippers' true value of entry capacity. This may lead to a significant reduction in the commodity charge coupled with high localised entry capacity prices and supply constraints, which might then be reversed should investment make more physical transportation and commercial entry capacity available.

The key to overcoming the high commoditisation issues is to make the combined capacity and commodity charges reflective of the locational cost of transportation capacity. As previously stated; the simplest solution is that already proposed i.e. removing the short term discounts and remembering that this was proposed as the first necessary step to precede discussions regarding the development of price multipliers for daily and monthly firm NTS Entry Capacity.

Alternative Solutions

If reliance on short term entry capacity further increased, as a result of short term capacity discounts being maintained, a commodity solution might need to be developed to avoid cross subsidies and inappropriate price signals which might result in inefficient by-pass of the NTS.

² No systems costs have been identified as a result of the potential implementation of GCM19, UNC0284 & UNC0285

Any solution would need to take into account long term capacity bookings already made or triggered as a consequence of requiring incremental entry capacity at a new ASEP. This might result in a complex process of allocating gas flows to classes of entry capacity held, and the application of different location specific commodity rates applying to each class of entry capacity. A further alternative approach might be to simply waive entry capacity charges if they were less than the relevant location specific entry commodity charges at an ASEP; effectively turning the entry charging arrangements into a form of take or pay.

Further consideration of all potential solutions might be required, but such commodity solutions are likely to result in increased complexity and significant systems development costs, and for these reasons National Grid NTS would not recommend this approach and believes the GCM19, UNC0284 and UNC0285 proposals are a more economic and efficient initial step.