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Date: 19 May 2011

Dear colleague

### **Decision Letter: Setting new revenue drivers, updating existing revenue drivers and adding new exit points to the Gas Transporter Licence**

On 22 March 2011, Ofgem<sup>1</sup> consulted<sup>2</sup> on our preferred approach to set revenue drivers<sup>3</sup> at the Tonna (Baglan Bay) (for gas to be delivered and used at Abernedd Power Station) and Pembroke (Phase 2) exit points. The consultation also described our intended approach to other issues, namely revising the capacity obligations of two existing revenue drivers and adding new exit points to National Grid Gas' (NGG's) Gas Transporter Licence (the "Licence").

Having considered the responses to our consultation and having regard to the principal objective and statutory duties<sup>4</sup> of the Authority and for the reasons set out in this letter, the Authority proposes to set revenue drivers at Tonna (Baglan Bay) and Pembroke (Phase 2) and to make the other changes as described below.

This letter provides:

- a short description of our consultation proposals;
- a summary of the consultation responses we received;
- Ofgem's views and final decision on these issues.

### **Background**

After the July 2010 exit capacity application window<sup>5</sup>, NGG asked us to set revenue drivers for incremental capacity at both Tonna (Baglan Bay) and Pembroke (Phase 2). The amounts of incremental capacity involved were:

- **Tonna (Baglan Bay):** 20.983 GWh/day from March 2015
- **Pembroke (Phase 2):** 20 GWh/day from October 2013

In August 2010 we asked NGG to undertake the necessary modelling work to derive revenue drivers for these capacities. The process and assumptions NGG used in their modelling work is described in more detail in our initial consultation letter<sup>6</sup>.

<sup>1</sup> Ofgem is the Office of Gas and Electricity Markets Authority. The terms 'Ofgem' and 'the Authority' are used

<sup>2</sup> "Open Letter Consultation: Setting new revenue drivers, updating existing revenue drivers and adding new exit points to the Gas Transporter Licence", Ofgem, 22 March 2011

<sup>3</sup> Revenue drivers enable NGG's allowed revenue to adjust upwards in response to financially backed incremental capacity signals from NTS users

<sup>4</sup> In particular those set out in Section 4AA of the Gas Act 1986, as amended.

<sup>5</sup> The annual application window is held under the rules of the Uniform Network Code (UNC) and allows NTS users to signal their future exit capacity needs.

<sup>6</sup> This can be found on the Ofgem website: <http://www.ofgem.gov.uk>

## Milford Haven flow assumption

Milford Haven<sup>7</sup> is an NTS entry terminal located close to both Abernedd and Pembroke Power Stations. The proximity of the Milford Haven pipeline to these power stations means that the entry flow assumption at Milford Haven has a significant impact on the potential reinforcement costs required to meet the incremental exit capacity demand.

NGG normally uses two winters worth of relevant entry capacity flow data in carrying out its modelling analysis. Since two winters worth of data at Milford Haven was not available when NGG began its modelling work, it assumed flows from Milford Haven of 166 GWh/day. This was the same flow assumption used by NGG in a similar revenue drivers setting exercise in 2009 before commercial flows began at Milford Haven.

Ofgem had concerns that this assumption was conservative. Our own analysis of Milford Haven flows suggested that supply flows above 383 GWh/day could be expected on such high demand days. Therefore, we consulted on revenue drivers based upon four different Milford Haven supply flow assumptions, ranging from 166 GWh/day to 300 GWh/day.

Our preferred approach was to assume supply flows of 300 GWh/day. Applying these supply flows to the unit costs assumptions for carrying out the reinforcement work gave the revenue driver amounts in Table 1 below.

**Table 1: Licence revenue driver figures under various options, 2005/6 prices**

£/GWh/year	Option 1a	Option 1b	Option 1c	Option 1d
Milford Haven flows (GWh/day)	<b>166</b>	<b>200</b>	<b>250</b>	<b>300</b>
Pembroke (Phase 2)	106,974	21,525	11,415	1,305
Tonna (Baglan Bay)	108,801	24,993	13,118	1,243

## Revision of revenue driver triggers at Marchwood and Pembroke

We also consulted on amending the project descriptions of existing revenue drivers at Marchwood and Pembroke (Phase 1). At TPCR 4, revenue drivers had been agreed at both exit points, with the assumption that 45 GWh/day of incremental capacity would be released at Marchwood and 87 GWh/day would be released at Pembroke (Phase 1).

However, when NGG signed Advanced Reservation of Capacity Agreements (ARCAs) for these exit points, the amounts of capacity noted in the ARCAs differed from the amount of capacity listed in the Licence. The table below shows the effect of this.

**Table 2: Marchwood and Pembroke (Phase 1) revenue driver values, 2005/6 prices**

	Licence project description (incremental capacity)	Annual revenue driver (£)	Capacity agreed in the ARCA
Marchwood	45 GWh/day	4,500,000	39.84 GWh/day
Pembroke (Phase 1)	87 GWh/day	6,400,000	103.2 GWh/day

NGG requested that we amend the Licence description to match the amount of capacity agreed in the ARCAs. This was largely a point for clarification of NGG's Licence obligations and does not affect NGG's associated revenues. Our preferred approach was to revise the project descriptions in line with NGG's request.

## Addition of new exit points to the Licence

NGG also requested that we add five new additional exit points to the Licence to allow Shippers to signal for incremental exit capacity. The new exit points requested are:

<sup>7</sup> Milford Haven is a Liquefied Natural Gas (LNG) terminal with an obligated capacity level of 950 GWh/day.

- Deborah Storage (Bacton)
- Tilbury Power Station
- Willington Power Station
- Cockenzie Power Station
- Saltfleetby Storage (Theddlethorpe).

Our preferred approach was to add these exit points.

### **Consultation responses**

There were four responses to the consultation. None of the responses were marked as confidential and each can be found on our website<sup>8</sup>.

#### *Milford Haven flow assumption*

Two of the respondents agreed with our preferred approach to assume flows of 300 GWh/day from Milford Haven. One respondent considered this was too conservative and a higher flow assumption could be made. NGG's response stated our preferred assumption was too optimistic.

The respondents who agreed with our preferred approach stated it was reasonable considering the strength of Ofgem's analysis and NGG's Milford Haven flow assumptions submitted in their Forward Business Plan Questionnaire (FBPQ) response. One of these respondents also noted that year round LNG imports will be a necessary feature of UK supplies to balance supply and demand, and provide responsiveness to demand fluctuations. As such they would expect a certain volume of baseload gas flow to come from LNG supplies such as Milford Haven.

The respondent who considered our assumption was too conservative stated that the gas Transmission Charging Methodology Forum (TCMF) had used December 2010 gas flows as a proxy for peak demand flows; they saw no reason why this is not suitable for Milford Haven flows. They said that with Ofgem's analysis also indicating that summer flows of 327 GWh/day could be expected from Milford Haven more than 84% of the time, the 300 GWh/day flow assumption represented a conservative view.

NGG disagreed with our position for several reasons. It considered that the use of the flow data in the FBPQ was inappropriate in this context, and highlighted possible factors or events that could curtail gas supply at Milford Haven. It also questioned aspects of our analysis, and reiterated its view that 166 GWh/day was an appropriate assumption to make for Milford Haven flows.

#### *Revision of revenue driver triggers at Marchwood and Pembroke*

Three of the respondents explicitly supported our preferred approach to amend the project descriptions. They noted that the proposals will tidy up the ambiguity between the amounts described in the Licence and the ARCAs.

One respondent questioned if our decision making process for these exit sites was consistent with the approach we took on the Fleetwood Income Adjusting Event (IAE)<sup>9</sup>. The respondent stated that NGG did not want the Fleetwood IAE to proceed as it would decrease revenues agreed as part of their price control settlement. The respondent considered that if the Fleetwood IAE was unsuccessful for this reason, proposals which increase NGG's price control settlement should likewise be ruled out.

<sup>8</sup> <http://www.ofgem.gov.uk>

<sup>9</sup> Fleetwood Income Adjusting Event decision letter, 9 May 2011, available on <http://www.ofgem.gov.uk>

### *Addition of new exit points to the Licence*

All respondents agreed that the proposed new exit points should be added to the Licence.

### **Ofgem's view**

We have carefully considered the responses to our initial consultation. In particular, we have reviewed our analysis of Milford Haven flow assumptions and NGG's critique of this.

When we published our initial consultation in March 2011, a complete two years worth of winter data for Milford Haven was not available. This meant we could not complete the revenue driver analysis using the same methodology employed in previous revenue driver setting processes.

We now have a full two winters worth of data for Milford Haven. Since the conclusion of the previous consultation, Ofgem and NGG both agreed to re-run the low local supply flow analysis using this complete two year dataset for Milford Haven. We considered this would ensure that the Tonna (Baglan Bay) and Pembroke (Phase 2) revenue drivers would be set consistently with existing ones.

Using a full two years of winter data in the low local supply flow assumption suggested that flows of around 381 GWh/day could be expected from Milford Haven on 95% of high demand days. In our view this provides further evidence that our approach to assume Milford Haven supply flows of 300 GWh/day is reasonable<sup>10</sup>. We have, therefore, decided to implement revenue drivers for Tonna (Baglan Bay) and Pembroke (Phase 2) assuming a supply flow of 300 GWh/day from Milford Haven.

### *Revision of revenue driver triggers at Marchwood and Pembroke*

We have decided to proceed with our preferred approach to revise the project descriptions in the Licence to reflect the capacity amounts agreed in the ARCAs. This will clarify NGG's Licence obligations and align them with user requirements (as signalled through ARCAs).

We still consider that these amendments will have no net effect on SO revenues or the SO commodity charge. Therefore, the comparison with the Fleetwood decision is not appropriate in this instance.

### *Addition of new exit points to the Licence*

We have decided to include the exit points listed above in the Licence. This will allow NGG to include these exit points in the July 2011 exit capacity application window invitation and for Shippers to signal for incremental capacity at those new exit points where a revenue driver is not required. As part of this process, we will also be proposing to designate them as "relevant points" for the purposes of complying with Article 18(4) Gas Regulation (EC) No 715/2009. We ask interested parties to detail in their consultation response whether they consider any of these points should not be defined as relevant points and the reason for their consideration only on an aggregated basis.

### *Other issues*

There are a number of other minor modifications we propose to make to the Licence, which we did not include in our initial consultation. These changes are not material and should help avoid confusion that may otherwise occur without making the modifications.

We propose removing the exit point known as Abernedd Power Station from the tables 1 and 2 of Annex A of Special Condition C8E. We did not consult on this amendment in our

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<sup>10</sup> It should be noted that the reduction in revenue driver for supplies in excess of 300 GWh/day is negligible

initial consultation paper as this modification has only recently been brought to our attention.

Abernedd Power Station is listed in tables 1 and 2 of Annex A as a Direct Connect (DC) offtake with a baseline of 0 GWh/day. It was included in the Licence when there was uncertainty as to where gas would be offtaken for the Abernedd Power Station.

We have been advised that all gas for this power station will be offtaken at Tonna (Baglan Bay). This renders the inclusion of Abernedd Power Station in Annex A redundant and could potentially create confusion for Shippers when applying for exit capacity.

It is our intention to remove the exit point from both tables to avoid any confusion and make it clear where Shippers should book exit capacity.

We also propose renaming the revenue driver known as 'Pembroke Power Station' to 'Pembroke (Phase 1)'. This change will better differentiate both revenue drivers and reduce any confusion between them. This change would not affect its status as a "Power Station" aggregated relevant point<sup>11</sup>.

### 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 Tonna (Baglan Bay) and Pembroke (Phase 2) as per Table 3.

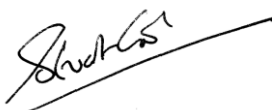
**Table 3: Final licence revenue drivers<sup>12</sup>**

<b>NTS Exit Point</b>	<b>Incremental exit capacity (GWh/day)</b>	<b>Revenue driver (£/GWh/year)</b>
Tonna (Baglan Bay)	20.983	1,243
Pembroke (Phase 2)	20	1,305

A full description of all other changes to the Licence the Authority proposes to make can be found in the Section 23 Gas Act 1986 Notice that accompanies this letter.

Representations or objections to the modifications proposed in the notice should be made by following the procedure set out at paragraph 7 of the notice. Please note that representations or objections must be made by 16 June 2011. Subject to any representations and National Grid Gas's consent, Ofgem intends to modify the licence condition by issuing a decision notice and a direction on 20 June 2011.

Yours sincerely



Stuart Cook  
**Senior Partner, Smarter Grids & Governance**  
**Signed on behalf of the Authority and authorised for that purpose**

<sup>11</sup> See "Authority's approval of "relevant points" of a transmission system for the purposes of Article 18 (4) Gas Regulation (EC) No 715/2009 and consultation questions on additional technical capacity information published by National Grid", Ofgem, 6 May 2011, for further details

<sup>12</sup> The revenue arising over the life of the associated assets should be no more than about £500,000

