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Email: [Chris.Logue@nationalgrid.com](mailto:Chris.Logue@nationalgrid.com)

Dear Chris

## **Approval of the Capacity Release and Capacity Methodology Statements (Special Licence Conditions 9A and 9B of National Grid Gas plc's Gas Transporter Licence<sup>1</sup>)**

Thank you<sup>2</sup> for submitting the proposed modifications to the two Capacity Release Methodology Statements and to the three Capacity Methodology Statements (collectively the 'Methodology Statements') to us<sup>3</sup> for approval on 24<sup>th</sup> May 2019. The proposed Methodology Statements were accompanied by the Independent Examiner's report and your Formal Consultation on Capacity Methodology Statements Conclusions Report ('Consultation Conclusions Report').

We have decided to approve the proposed Methodology Statements. The background and reasons for our decision are explained below.

### **Background**

The Methodology Statements set out how users can obtain access to National Transmission System (NTS) entry and exit capacity.

The three 'Capacity Methodology Statements' developed pursuant to Special Condition 9A of your Licence are:

- The Entry Capacity Substitution Methodology Statement (the 'ECS').
- The Exit Capacity Substitution and Exit Capacity Revision Methodology Statement (the 'ExCS').
- The Entry Capacity Transfer and Entry Capacity Trade Methodology Statement (the 'ECTT').

The two 'Capacity Release Methodology Statements' developed pursuant to Special Condition 9B of your Licence are:

- The Entry Capacity Release Methodology Statement (the 'ECR').
- The Exit Capacity Release Methodology Statement (the 'ExCR').

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<sup>1</sup> The terms 'NGG's Licence', 'your Licence' are used to refer to National Grid Gas Plc (NTS) Gas Transporter Licence.

<sup>2</sup> The terms 'the licensee', 'NGG' and 'you' are used to refer to National Grid Gas in this letter.

<sup>3</sup> The terms "the Authority", 'Ofgem', 'we', 'us' and 'our' are used interchangeably in this letter.

Special Conditions 9A.6 and 9B.8 of your Licence provide that the Licensee must, if so directed by the Authority, and in any event at least once every two years, review the Methodology Statements<sup>4</sup>. You must seek to make such modifications to the Methodology Statements as you consider are reasonably necessary to better facilitate the achievement of the capacity objectives set out in Special Condition 9A.5 of your Licence.

As part of the review, you proposed substantial changes to the Capacity Release Methodology Statements (the ECR and the ExCR), and minor, housekeeping changes to the Capacity Methodology Statements (the ECS, ExCS and ECTT).

In accordance with Special Conditions 9A and 9B you consulted<sup>5</sup> with relevant stakeholders, prior to submitting the proposed modifications to the Authority. You identified changes made following the consultation within a Consultation Conclusions Report. The consultation responses and the Consultation Conclusions Report are available on your website<sup>6</sup>.

In accordance with Special Licence Condition 9B.9, you also submitted the Independent Examination's report to us. This is in line with our Decision to approve the scope and objectives for an Independent Examination of the Capacity Release Methodology Statements<sup>7,8</sup> published on 13<sup>th</sup> December 2018. The report examined the extent that the proposed ECR and ExCR are consistent with your duties and objectives under your Licence, the Gas Act and the Uniform Network Code (the 'UNC').

## **Proposed Changes to the Methodology Statements**

### *The ECR*

As part of the review, you substantially revised the ECR. This was to make changes to the Net Present Value ('NPV') Test, driven by the anticipated replacement of the Long Run Marginal Cost (LRMC) methodology to ensure compliance with EU Tariff Code (Regulation 2017/460, 'TAR NC'). You have substantially revised Chapters 5, 6, 7 and Appendix 1, and made other minor amendments to align the text with the UNC following modifications UNC616S and UNC628S.

The proposed NPV Test is not dependent on any particular outcome of the anticipated replacement of the LRMC methodology, and is proposed to apply from the day a new charging methodology is in place. Your proposals included changes in the approach to project cost. You propose that project cost is determined on the basis of the Estimated Project Cost Methodology ('EPCM'), which is in Appendix 1. Project cost will be locked in prior to capacity reservation at the end of PARCA Phase 1. Before allocation of capacity at the end of PARCA Phase II, project cost is adjusted for inflation to provide the final estimated project cost.

You proposed to introduce a capacity premium and a 'PARCA minimum duration requirement'<sup>9</sup> for any capacity applied for through a PARCA. The proposed minimum

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<sup>4</sup> The Methodology Statements were last reviewed in July 2017.

<sup>5</sup> The consultation ran between 16<sup>th</sup> April and 14<sup>th</sup> May 2019. You also held a preliminary consultation in January 2019 (from 16<sup>th</sup> January to 15<sup>th</sup> February 2019) to give yourself more time to engage with industry as you developed the proposals.

<sup>6</sup> <https://www.nationalgridgas.com/capacity/capacity-methodology-statements>.

<sup>7</sup> A copy of our decision can be found on our website:

[https://www.ofgem.gov.uk/system/files/docs/2018/12/decision\\_regarding\\_the\\_scope\\_and\\_objectives\\_for\\_an\\_independent\\_examination\\_of\\_the\\_review\\_of\\_the\\_entry\\_and\\_exit\\_capacity\\_release\\_methodology\\_statements.pdf](https://www.ofgem.gov.uk/system/files/docs/2018/12/decision_regarding_the_scope_and_objectives_for_an_independent_examination_of_the_review_of_the_entry_and_exit_capacity_release_methodology_statements.pdf)

<sup>8</sup> You requested our consent not to submit a statement from the Independent Examiner accompanying the modifications to the three Capacity Methodology Statements, on the basis that only minor, housekeeping changes were required and that an Independent Examiner statement would provide little valuable additional information regarding your compliance with your obligations under your Licence and duties under the Gas Act. On the 13<sup>th</sup> December 2018 we consented to your request and therefore no Independent Examination report was submitted to accompany the review of the Capacity Methodology Statements. A copy of our decision can be found here:

[https://www.ofgem.gov.uk/system/files/docs/2018/12/consent\\_to\\_ngg\\_to\\_submit\\_three\\_methodology\\_statements\\_unaccompanied\\_by\\_an\\_independent\\_examiner\\_statement.pdf](https://www.ofgem.gov.uk/system/files/docs/2018/12/consent_to_ngg_to_submit_three_methodology_statements_unaccompanied_by_an_independent_examiner_statement.pdf)

<sup>9</sup> The previous Economic Test capped the price at P20 and as a result implicitly required a duration requirement.

duration requirement is intended to signal a sustained need for capacity and would not be less than 16 quarters, as currently defined in the UNC.

### *The ExCR*

The main proposed changes to the ExCR were to improve the processes to release Exit Capacity, including the way you will process ad-hoc applications during the PARCA window. You have added text about withholding daily capacity from sale in the event of a constraint, and made other minor amendments to align the text with the UNC following relevant UNC modifications UNC626S and UNC628S.

You propose minor, typographical changes to the *ECS, ExCS and ECTT*.

## **Consultation Responses**

Five stakeholders responded to the consultation on the proposed changes to the Methodology Statements. The consultation responses and the Consultation Conclusion Report have been published on your website<sup>10</sup>.

User Commitment was identified by three of the five respondents. Two of these respondents proposed a holistic review of the User Commitment rules. Two respondents expressed their concerns that the insertion of the EPCM into the ECR will introduce an imbalance in governance between the UNC and the ECR. We do not consider this to be a major concern and have not seen any evidence that what you propose will not work.

Two stakeholders objected to the proposed text in the ExCR saying you could withhold firm exit capacity from auction if there is a system constraint. They had the same concerns about text that is already in the ECR which says the same.

One respondent said that requests for increases to enduring levels of NTS Exit (Flat) Capacity made during the Annual Application Window will put users at a disadvantage as capacity can be substituted away without the donor being given the opportunity to challenge. One respondent was opposed to the inclusion of text describing existing arrangements for competing auctions in the ECR and ExCR.

## **Independent Examiner statement**

The Independent Examiner statement was submitted with the proposed modified ECR and ExCR as required by Special Licence Condition 9B.9.

The Independent Examiner has confirmed that you have developed the proposed ECR and ExCR in line with the duties and objectives under the Gas Act and your Licence and consistent with the processes described by the UNC. This satisfies the requirements of paragraph 7 of Special Condition 9A.

The Independent Examiner said that five parameters in the ECR and ExCR can be viewed as arbitrary. These are, for the NPV Test: the minimum PARCA duration requirement; the four quarters in each of four years' duration threshold for the release of incremental capacity, and; the 50% financial commitment threshold. They are, for the ExCR: the four-year duration of the User Commitment, and; the 50% threshold that applies to the Economic Test for the release of incremental capacity at interconnection points.

The Independent Examiner said that significant analysis would be required to produce economically justifiable figures to replace these five parameters and that it had no evidence that indicated that there is a need to revise these figures upwards or downwards.

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<sup>10</sup> Please see the following link: <https://www.nationalgridgas.com/capacity/capacity-methodology-statements>

The Independent Examiner said that there is limited evidence that withholding obligated capacity from the daily allocation processes where you foresee a constraint is economically efficient.

On the NPV Tool, the Independent Examiner made two observations:

- The discount formula which is used in the NPV Tool, is not the formula that would typically be expected in a discounted cash-flow analysis. The use of the formula in the Tool compared to the widely used version understates the discounted revenues by around 1%.
- The reason for the using 5.05% as the discount rate in the NPV Test could not be established.

## **Our View**

We have considered the changes proposed in the Methodology Statements. We have considered and taken into account the consultation responses and the further amendments to the proposed modified Methodology Statements you have made following consultation. We have considered and taken into account the Independent Examination's report.

We consider that, overall, the proposed amendments to the Methodology Statements better meet the capacity objectives set out in paragraph 5 of Special Condition 9A. We think that the proposed amendments to the ECR and ExCR will continue to help you determine whether to release Entry and Exit Capacity to Shipper Users, and in what quantities, once the anticipated changes to the charging methodology as required by TAR NC are put in place.

In paragraph 54 of the ECR you propose to remove the explicit reference to the 16 quarter duration requirement for capacity reservation requests which can be met through substitution. Instead you have inserted a link to the PARCA minimum duration quantity, as defined in the UNC Section B 1.17.7(c)(ii). This will mean that if the relevant rule in the UNC changes then the relevant rules in the ECR for substitution and funded incremental capacity will move in line. This means that there will be the same duration requirements for substitution and for reservations of existing capacity via the PARCA process. You intend that this will avoid situations where Users prefer connections at constrained parts of the network.

We understand that this change was initiated to respond to the industry's requests to relax or remove the duration requirements for incremental capacity. We understand that given the uncapped premium, the duration requirement guarantees sustained demand, rather than a User signalling the need for capacity over a short period of time through a very high premium. At Work Group meetings, industry representatives discussed what, if any, duration requirements there should be for incremental capacity release, given that a financial commitment of 50% is required for incremental capacity release. (No financial commitment is required for substitution or existing obligated capacity.)

Stakeholders raised issues concerning user commitment. However, the rule associated with substitution is outside of the scope of this review of the Methodology Statements as it is a UNC requirement. We note here that NGG is currently leading on a review of access arrangements and the rules around substitution.

One respondent made comments about references to competing auctions in the ECR and ExCR. You have clarified that these references have been added in response to a request to clarify whether or not competing auctions can apply at Moffat. You note that competing auctions are already in place on entry at Bacton IP and on exit at Moffat. You said that paragraphs 187 in the ECR and 190 in the ExCR apply to these two points currently.

We note the clarifications you provided to stakeholders and the Independent Examiner with regard to withholding capacity from daily allocation when you foresee a constraint. You said that continuing to sell capacity into a constraint would increase constraint management costs significantly, with the cost ultimately passed on to consumers. You also said that this practice is covered by the System Management Principles, which have recently gone through industry consultation, and explained that you would in the first instance scale back interruptible capacity before considering any action related to firm capacity. We expect that you will continue to act in compliance with your obligations.

You have told us that, by 24 July 2019, when the Methodology Statements enter into force, you will have corrected *the errors in the Excel-based NPV Test tool* as follows:

- Replaced the discount formula which is currently used in the NPV Tool with the formula that would typically be expected in a discounted cash-flow analysis as suggested by the Independent Examiner; and
- Updated the 5.05% discount rate used in the NPV Test.

Correcting these errors in the NPV test tool does not require any change in the wording of the Methodology Statements.

### **Our decision**

Following consideration of the documentation you provided pursuant to Special Condition 9A and 9B of the Licence, we consider that the proposed amendments to the Methodology Statements better meet the capacity objectives set out in paragraph 5 of Special Condition 9A. We have therefore decided to approve the proposed Methodology Statements.

This letter has been made available on our website. You can contact Lea Slokar at [Lea.Slokar@ofgem.gov.uk](mailto:Lea.Slokar@ofgem.gov.uk) or on 020 7901 7005 if you have any questions about this decision.

Yours sincerely,

**David O'Neill**

**Head of Gas Systems, Energy Systems Transition**

Signed on behalf of the Authority and authorised for that purpose