CONSULTATION DOCUMENT

Modification Proposals to the Gas Transmission Transportation Charging Methodology

NTS GCM 18:

NTS Entry Capacity Retention Charges

11 August 2009

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1 Executive Summary

This document is issued by National Grid Gas plc ("National Grid") in its role as holder of the Gas Transporter Licence in respect of the NTS (the "Licence").

This document sets out for consultation a proposal for amending the Gas Transmission Transportation Charging Methodology (the "Charging Methodology") in respect of the introduction of an NTS Entry Capacity Retention Charge.

This proposal, GCM18, would also ensure that revenue recovered from Users in regard to the proposed NTS Entry Capacity Retention Charges would appropriately offset other NTS transportation charges.

GCM18: National Grid proposes through this consultation document that:

- NTS Entry Capacity Retention Charges in regard to non-incremental obligated entry capacity would be calculated based on the minimal capacity charge rate of 0.0001 pence per kWh per day applying over a time period of 32 quarters; this equates to 0.2920 p/kWh of entry capacity retained.
- NTS Entry Capacity Retention Charges and refunds in regard to non-incremental obligated entry capacity would be treated as TO revenue;
    - this would result in reduced TO Entry Commodity Charges in the case of charges incurred for retained capacity or increased TO Entry Commodity Charges in the case of subsequent refunds.

Implementation

It is proposed that these arrangements are implemented with effect from 8 December 2009 to be consistent with the approval by the Authority, if given, of the Entry Capacity Substitution Methodology Statement (the "substitution methodology statement"). These arrangements would therefore be applicable to the retention of entry capacity that could otherwise be substituted in auctions on or after 1 March 2010.

The closing date for submission of your responses to this consultation is **14 September 2009.**

2 Introduction

2.1 This document is issued by National Grid Gas plc ("National Grid") in its role as holder of the Gas Transporter Licence in respect of the NTS (the "Licence").

2.2 This document sets out for consultation a proposal for amending the Gas Transmission Transportation Charging Methodology (the "Charging Methodology") in respect of the introduction of an NTS Entry Capacity Retention Charge.

2.3 This proposal, GCM18, would ensure that revenue recovered from Users in regard to NTS Entry Capacity Retention Charges would appropriately offset other NTS transportation charges.

3 Background

3.1 The 2007 Transmission Price Control Review created a new obligation on National Grid to undertake Entry Capacity Substitution (see Licence condition C8D paragraph 10 and C8A paragraph 1). This obligation requires National Grid to use reasonable endeavours to undertake entry capacity substitution when proposing to release capacity incremental to the prevailing level of obligated entry capacity, thus seeking to minimise the amount of investment that is required to satisfy incremental demand.

3.2 Substitution is where National Grid moves unsold non-incremental entry capacity from one ASEP to meet the demand for incremental obligated entry capacity at a different ASEP.

3.3 In accordance with the Licence, National Grid is required to implement Entry Capacity Substitution from, and including, the March 2010 QSEC auction and is required to submit its proposed Methodology Statement to the Authority for approval no later than 7th September 2009.

3.4 After a series of industry workshops throughout 2008 and 2009, and an informal consultation in May 2009, a proposed substitution methodology statement was submitted to the industry for formal consultation* on the 24th July 2009. This proposed methodology is based on the "Options Approach" developed through the workshops. To avoid confusion with other Option products, references to "Options" have been replaced with "Retainer" as this more accurately describes the role of the product.

3.5 Assuming the substitution methodology statement is approved and substitution is implemented in accordance with the proposed methodology, Users will be able to exclude unsold non-incremental obligated entry capacity at potential donor ASEPs from being substituted away, in response to an incremental signal elsewhere, by the purchase of a Retainer. The rules and processes for Retainers are detailed in the proposed substitution methodology statement which includes the requirement for a charge to be paid in respect of a Retainer.

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* This can be found on National Grid's website at http://www.nationalgrid.com/uk/Gas/Charges/statements/transportation/ecms/

3.6 Concurrent to this charging proposal and the substitution methodology statement consultation, National Grid will raise an associated UNC Modification Proposal. The UNC Modification Proposal is required to define the NTS Entry Capacity Retention Charge as a Transportation Charge within the UNC and so allow National Grid the ability to invoice for the revenue associated to this charge; hence, approval of this proposal is integral to the implementation of entry capacity substitution.

4 Discussion and Issues

Introduction

4.1 A Modification to the NTS Charging Methodology is required to define the calculation of the NTS Entry Capacity Retention Charge rate and so that charges can be treated appropriately in accordance with the Licence. An associated UNC modification proposal will define the introduction of the charge whilst the proposal laid out in this document defines the rate and maps the charge on to the relevant price control terms. This would allow the mapping of the charges (and where appropriate, refunds) to TO collected revenue[*], as required, and allow the consequential recalculation of other existing charges taking into account revenues resulting from the NTS Entry Capacity Retention Charges.

Relevant Licence Objectives

4.2 The Licence requires that proposed changes to the Charging Methodology shall achieve the relevant methodology objectives.

4.3 Where transportation prices are not established through an auction, prices calculated in accordance with the methodology should:

- 1) Reflect the costs incurred by the licensee in its transportation business;
- 2) So far as is consistent with (1) properly take account of developments in the transportation business;
- 3) So far as is consistent with (1) and (2) facilitate effective competition between gas shippers and between gas suppliers.

Costs Avoided by Substitution

4.4 In seeking to define a cost reflective retention charge, National Grid has estimated the potential avoided costs of entry capacity substitution.

4.5 In each QSEC auction a quantity of incremental entry capacity may be released. This would result in incremental allowed revenue and an ongoing cost to the industry, were this to be met through investment and not substitution, hence this should represent the avoided cost if this incremental entry capacity were to be met through substitution.

4.6 The cost potentially avoided through substitution has been estimated from the average of the capitalised licence defined revenue drivers from the two ASEPs where incremental entry capacity has been released during the current price control. This represents the costs that have been incurred i.e. the investment costs that might otherwise be avoided through substitution.

[*] Capacity that could be substituted in a QSEC auction is restricted to non-incremental obligated entry capacity (essentially baseline capacity) and therefore any resulting revenues are treated under the Licence as TO.

4.7 A Retainer would prevent capacity from being substituted to meet an incremental signal. If Retainers were taken out on all substitutable capacity, it would not be possible to undertake substitution and therefore the above costs would definitely have been realised in meeting an incremental signal even if substitution was in force. Therefore the amount of substitutable capacity represents the maximum chargeable quantity.

4.8 An initial unit rate for the NTS Entry Capacity Retention Charge can be calculated as the estimate of the avoided cost divided by the maximum substitutable quantity.

4.9 Appendix A outlines a potential calculation (Methodology A) which would result in an initial rate for the NTS Entry Capacity Retention Charge of £175,111 per 1 mscm/d of capacity retained;

4.10 There are several issues and factors that would need to be taken into account to turn this “raw” charge into a cost reflective charge:

- The calculation is based on a forward projection using historic costs (i.e. historic incremental capacity releases) and therefore is not strictly reflective of the costs incurred as required of administered prices under the Licence.
- The calculation requires a probability of whether incremental entry capacity would be signalled at each QSEC auction and whether this could be met through substitution or not.
- The avoided costs are based on all substitutable capacity being retained however if only half the substitutable capacity is retained there is still remains a probability that substitution could occur. The determination of avoided costs is therefore imprecise.

4.11 Based on the difficulties of determining a cost reflective charge as described above, National Grid has considered an alternative approach to comply with the other relevant charging obligations. See paragraph 4.12 below.

Alternative Approach

4.12 Where transportation prices are not established through an auction, prices calculated in accordance with the methodology should properly take account of developments in the transportation business and facilitate effective competition between gas shippers and between gas suppliers subject to the cost reflectivity objective.

4.13 An alternative to considering the costs avoided by substitution is to consider a calculation based on the minimum entry capacity charge rate of 0.0001p/kWh/day that applies in all QSEC auctions. This is currently applicable at nine ASEPs and a Shipper at these ASEPs could protect capacity from being substituted by buying a sufficient number of quarters in the QSEC auction at this minimum price.

4.14 In the development of the substitution methodology statement there has been significant discussion on Shippers potentially booking a single quarter to frustrate the substitution process, therefore it would not seem consistent to base the NTS Entry Capacity Retention Charge on a single quarter booking at minimum price.

4.15 To determine the period for applying the minimum price, reference has been made to the qualifying time period of 32 quarters used within the economic test for release of incremental entry capacity.

4.16 Based on paragraph 4.15, National Grid believes that a time period of 32 quarters would be appropriate for determining the NTS Entry Capacity Retention Charge.

4.17 Appendix A also details this alternative calculation (Methodology B) which would result in a retention charge rate of £32,120 per 1 mscm/d of capacity retained. This is around 18% of the charge rate in paragraph 4.9 above, which based on the uncertainties detailed would seem to be a more appropriate level for a retention charge. Setting the charge at this rate should also encourage uptake of this product at all ASEPs rather than only at those with high reserve prices.

4.18 National Grid would intend to keep this proposed charge rate under review, to take account of information that becomes available on the effect and likelihood of substitution.

Licence

4.19 The NTS Entry Capacity Retention Charge would need to be determined in accordance with the NTS Charging Methodology, in compliance with the following NTS Licence condition, in order for it to offset other NTS charges;

- Standard Special Condition C8B 2(a); Definition of TORCOMt ~ TO revenue other than that collected through capacity charges.

4.20 NTS Entry Capacity Retention Charges in regard to non-incremental obligated entry capacity that would have resulted in TO revenue would be treated as TO entry revenue; this would result in reduced (or, in respect of refunds, increased) TO Entry Commodity Charges.

Commodity Charge Impact

4.21 Shippers can calculate the approximate impact on their net entry commodity charges of the revenue received from any capacity NTS Entry Capacity Retention Charges.

4.22 Every £1m of entry revenue arising from retention charges received in relation to capacity that would have been treated as TO revenue will result in a 0.0001 p/kWh reduction in the TO Entry Commodity charge over a 12 month period.

4.23 The NTS Entry Capacity Retention Charge will be treated as income in the year in which it is invoiced*.

4.24 If the collection of a retention charge could not be reflected in TO Entry Commodity charges within the relevant formula year due to the timing of the invoice, the TO entry commodity charge rebate or the TO entry commodity charge credit would be used to return any TO over recovery in excess of £1m. In this instance the rebate or credit would be paid following the end of the formula year. For any TO over recovery below this £1m threshold the value would flow through TOK to the following formula year and the impact would be only on the TO Entry Commodity charge in the following formula year due to the separate treatment of over and under recovery of TO allowed revenue within the Charging Methodology.

* Notwithstanding that a Retainer taken out in January 2010 and applicable to the March 2010 QSEC auction (plus any ad-hoc QSEC auctions) will be invoiced in June 2010 i.e. in the next formula year.

5 National Grid's Proposal

5.1 National Grid proposes through GCM18 that:

- NTS Entry Capacity Retention Charges in regard to non-incremental obligated entry capacity would be calculated based on the minimal capacity charge rate of 0.0001 pence per kWh per day applying over a time period of 32 quarters; this equates to 0.2920 p/kWh of entry capacity retained.
- NTS Entry Capacity Retention Charges and refunds in regard to non-incremental obligated entry capacity would be treated as TO revenue;
    - This would result in reduced TO Entry Commodity Charges in the case of charges incurred for retained capacity or increased TO Entry Commodity Charges in the case of subsequent refunds.

<u>Implementation</u>

It is proposed that these arrangements are implemented with effect from 8 December 2009 to be consistent with the approval by the Authority, if given, of the substitution methodology statement. These arrangements would therefore be applicable to the retention of capacity that could otherwise be substituted in auctions on or after 1 March 2010.

6 Justification

Assessment against Licence Objectives

6.1 The Licence requires that proposed changes to the Charging Methodology shall achieve the relevant methodology objectives.

6.2 Where transportation prices are not established through an auction, prices calculated in accordance with the methodology should:

- 1) Reflect the costs incurred by the licensee in its transportation business;
- 2) So far as is consistent with (1) properly take account of developments in the transportation business;
- 3) So far as is consistent with (1) and (2) facilitate effective competition between gas shippers and between gas suppliers.

6.3 National Grid believes that GCM18 would satisfy the relevant objectives as it would properly take account of developments in the transportation business should the relevant UNC proposal be directed for implementation and the substitution methodology statement be approved.

Assessment against EU Gas Regulations

6.4 EC Regulation 1775/2005 on conditions for access to the natural gas transmission networks (binding from 1 July 2006) are summarised below. The principles for network access tariffs or the methodologies used to calculate them shall:

- Be transparent
- Take into account the need for system integrity and its improvement
- Reflect actual costs incurred for an efficient and structurally comparable network operator
- Be applied in a non-discriminatory manner
- Facilitate efficient gas trade and competition
- Avoid cross-subsidies between network users
- Provide incentives for investment and maintaining or creating interoperability for transmission networks
- Not restrict market liquidity
- Not distort trade across borders of different transmission systems.

6.5 National Grid believes that GCM18 is consistent with the principles listed above, specifically the amended methodology should;

- Be applied in a non-discriminatory manner
- Avoid cross-subsidies between network users
- Not distort trade across borders of different transmission systems.

7 Questions for Consultation

7.1 National Grid invites views on whether the proposed changes to our Gas Transmission Transportation Charging Methodology meet the Licence objectives, specifically that:

- NTS Entry Capacity Retention Charges in regard to non-incremental obligated entry capacity would be calculated based on the minimal capacity charge rate of 0.0001 pence per kWh per day applying over a time period of 32 quarters; this equates to 0.2920 p/kWh of entry capacity retained.
- NTS Entry Capacity Retention Charges and refunds in regard to non-incremental obligated entry capacity would be treated as TO revenue;
    - This would result in reduced TO Entry Commodity Charges in the case of charges incurred for retained capacity or increased TO Entry Commodity Charges in the case of subsequent refunds.

Implementation

- It is proposed that these arrangements are implemented with effect from 8 December 2009 to be consistent with the approval by the Authority of the Substitution Methodology. These arrangements would therefore be applicable to the retention of capacity that could otherwise be substituted in auctions on or after 1 March 2010.

The closing date for submission of your responses is **14 September 2009**.

Your response should be e-mailed to:

box.transmissioncapacityandcharging@uk.ngrid.com

or alternatively sent by post to

Debra Hawkin, Regulatory Frameworks, National Grid, National Grid House, Gallows Hill, Warwick, CV34 6DA.

If you wish to discuss any matter relating to this charging methodology consultation then please call Debra Hawkin☎ 01926 656317 or Jemma Spencer ☎ 01926 654212.

Responses to this consultation will be incorporated within National Grid's conclusion report. If you wish your response to be treated as confidential then please mark it clearly to that effect.

Appendix A

METHODOLOGY A		SO Revenue over 5 years[1]
Average Revenue Driver (£m)[2]	**A**	£36.34
Substitutable Capacity (GWh)	**B**	2,283.0
Retention Charge Rate (p/kWh)	**C=(100*A)/B**	1.5919
Example retention of 10 mscm/day		
Retained Daily Capacity Quantity (mscm/day)	**D**	10.0
Retained Daily Capacity Quantity (GWh/day)	**E**	110.0
Charge to retain (£)	**F=10^6*C*E/100**	£1,751,106
Retention Charge Rate (£/mscm/d)	**C_1=F/10**	£175,111
METHODOLOGY B		
Minimum price over 32 quarters[3] ***Example retention of 10 mscm/day***	-	
Minimum Price (p/kWh/day)	**G**	0.0001
Charge for retaining 10mscm at an ASEP (£)	**H=(8*365)*G*E*10^6/100**	£321,200
Retention Charge Rate (p/kWh)	**I=H*100/(E*10^6)**	0.292
Retention Charge Rate (£/mscm/d)	**I_1=H/10**	£32,120

Notes:

1. The revenue drivers are at 04/05 prices.
2. It has been assumed that there is one incremental signal that could be met by substitution per year. The revenue driver used in the calculation is an average of the revenue drivers associated with incremental signals for capacity released in the present price control.
3. Thirty two quarters (or eight years) has been used in this alternative calculation for the reasons detailed in section 4.15 above.