

GCM11 Veto - Further TO Over Recovery Options

Gas TCMF

8th April 2008

Issue

- ◆ Ofgem vetoed GCM11
 - ◆ GCM11 would have led to minimal Entry Over recovery
 - ◆ Entry Under recovery would lead to Exit cross subsidising Entry Users, and
 - ◆ Exit Users would gain minimal benefit from Entry over-recovery.
- ◆ Issue
 - ◆ Ofgem argue that this would be asymmetric, and the status quo (with GCM10 implemented) is symmetric.
 - ◆ Ofgem comment that capacity auctions may reflect market value rather than cost

Options

- ◆ Do Nothing
 - ◆ Over recovery would be redistributed in the following formula year via the setting of entry and exit prices to seek to collect TO allowed revenue on a 50-50 entry-exit basis
- ◆ Explicitly reduce exit charges
 - ◆ Licence reasonable endeavours obligation to reset exit prices no more than once a year and on 1st October
 - ◆ Not consistent with a monthly Trade & Transfer process
- ◆ GCM11 + Manage the K mechanism separately for entry and exit – exact symmetry

Separate Management of K for Charge Setting Purposes

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TO Over/Under Risk Mitigation

| Risk | Mitigation |
|-------------------------|--|
| TO Exit Under-recovery | Administered prices (100% Capacity hence no weather risk) |
| TO Exit Over-recovery | |
| TO Entry Under-recovery | Reserve prices and TO Entry Commodity charge |
| TO Entry Over-recovery | Buy-back offset mechanism & TO Entry Commodity Rebate – No mechanism for pure auction over-recovery > buy-back costs |

Potential Additional Methodology Process

- ◆ GCM11 + Separate Management of entry and exit 'K' for charging purposes only
 - ◆ GCM11 plus
 - ◆ The TO K mechanism amount, *defined within the Licence as the difference between allowed revenue and collected revenue inflated for the average specified interest rate*, would be attributed to entry and exit separately for charge setting purposes only.
 - ◆ Calculation depends on net under or over recovery

'K' Entry/Exit Management Mechanism

| Net Position | Exit | Entry | Calculation |
|--------------------|---------------------|----------------------|---|
| Net Over Recovery | Exit Over-recovery | Entry Under-recovery | $\text{TOKEN}_t = (\text{TOREn}_{t-1} - \text{TOMAREn}_{t-1}) \times (1 + \text{IR}_t/100)$ $\text{TOKEx}_t = \text{TOK}_t - \text{TOKEN}_t$ |
| | Exit Under-recovery | Entry Over-recovery | $\text{TOKEx}_t = (\text{TOREx}_{t-1} - \text{TOMAREx}_{t-1}) \times (1 + \text{IR}_t/100)$ $\text{TOKEN}_t = \text{TOK}_t - \text{TOKEx}_t$ |
| | Over Recovery | | $\text{TOKEx}_t = (\text{TOREx}_{t-1} - \text{TOMAREx}_{t-1}) \times (1 + (\text{IR}_t + \text{PI}_t)/100)$ $\text{TOKEN}_t = (\text{TOREn}_{t-1} - \text{TOMAREn}_{t-1}) \times (1 + (\text{IR}_t + \text{PI}_t)/100)$ |
| Net Under Recovery | Exit Over-recovery | Entry Under-recovery | $\text{TOKEx}_t = (\text{TOREx}_{t-1} - \text{TOMAREx}_{t-1}) \times (1 + \text{IR}_t/100)$ $\text{TOKEN}_t = (\text{TOREn}_{t-1} - \text{TOMAREn}_{t-1}) \times (1 + \text{IR}_t/100)$ |
| | Exit Under-recovery | Entry Over-recovery | |
| | Under Recovery | | |

Where

TOKEN_t ~ TO Entry Revenue adjustment factor in respect of formula year t for charging purposes

TOREn_{t-1} ~ TO Entry Revenue collected in year t-1

TOMAREn_{t-1} ~ TO Maximum Allowed Revenue allocated to Entry in the Charging Methodology

IR_t ~ Percentage interest rate in respect of formula year t [Licence Special Condition C8B (3)(d)]

PI_t ~ Penalty interest rate in respect of formula year t [Licence Special Condition C8B (3)(d)]

TOK_t ~ Revenue adjustment factor in respect of formula year t [Licence Special Condition C8B (3)(d)]

TOKE_t ~ TO Exit Revenue adjustment factor in respect of formula year t for charging purposes

TOREx_{t-1} ~ TO Exit Revenue collected in year t-1

TOMAREx_{t-1} ~ TO Maximum Allowed Revenue allocated to Exit in the Charging Methodology

Examples (prior to GCM10/11)

| Entry | Exit | Total | K | Existing | Proposed | |
|-------|------|-------|----------------------------|--------------|----------|--------|
| | | | Prior to GCM10/11 payments | Entry/Exit K | Entry K | Exit K |
| -100 | -100 | -200 | -210.0 | -105.0 | -105.0 | -105.0 |
| -100 | 50 | -50 | -52.5 | -26.25 | -105.0 | 52.5 |
| 100 | -150 | -50 | -52.5 | -26.25 | 105.0 | -157.5 |
| -100 | 150 | 50 | 54.0 | 27 | -105.0 | 159.0 |
| 100 | -50 | 50 | 54.0 | 27 | 106.5 | -52.5 |
| 100 | 100 | 200 | 216 | 108 | 108.0 | 108.0 |

K = Actual minus Allowed Revenue.

(Positive = Over-recovery, Negative=under-recovery, K is subtracted from allowed revenue in the following year)

Interest rate assumed ~ 5.00% under-recovery, 8% over-recovery

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Examples

| Entry | Exit | Total | K | Existing | Proposed | |
|-------|------|-------|-------------------------------|------------------|----------|--------|
| | | | After GCM10/11 payments | Entry/ Exit K | Entry K | Exit K |
| -100 | -100 | -200 | -210.0 | -105.0 | -105.0 | -105.0 |
| -100 | 50 | -50 | -52.5 | 26.25 | -105.0 | 52.5 |
| 0 | -150 | -150 | -157.5 | -78.75 | 0 | 157.5 |
| -100 | 150 | 50 | 54.0 | 27 | -105.0 | 159.0 |
| 0 | -50 | -50 | -52.5 | -26.25 | 0 | 52.5 |
| 0 | 100 | 100 | 108 | 54 | 0 | 100 |

K = Actual minus Allowed Revenue.

(Positive = Over-recovery, Negative=under-recovery, K is subtracted from allowed revenue in the following year)

Interest rate assumed ~ 5.00% under-recovery, 8% over-recovery

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Implementation

- ◆ Earliest implementation 1st October 2008
- ◆ Key charges which ensure TO Revenue recovery.....
 - ◆ TO Exit Capacity Charge
 - ◆ TO Entry Commodity Charge
- ◆are reset at this time to aim to recover the TO allowed revenue within the formula period.
- ◆ Alternative implementation 1st April 2009

Views?

Consultation Options

- ◆ Discussion followed by Consultation
- ◆ Draft Consultation for comment followed by Consultation
- ◆ Straight to Consultation

Views?

Potential Charging Methodology Proposal

Timelines

| Milestone | Date | Date |
|--|------------------------------|-------------------------------|
| Charging Methodology Proposal issued | April/May 2008 | September 2008 |
| Consultation Ends | May/June 2008 | Sept/Oct 2008 |
| Consultation Conclusions Report inc. Final Proposals | June 2008 | Oct/Nov 2008 |
| Ofgem veto period ends (Assumes no Impact Assessment) | July 2008 | Nov/Dec 2008 |
| Notice of Charges | 1 st August 2008 | 1 st February 2009 |
| Implementation | 1 st October 2008 | 1 st April 2009 |