

CONSULTATION DOCUMENT

Modification Proposals to the Gas Transmission Transportation Charging Methodology

**NTS GCM 09:
TO Over Recovery Mechanism**

14th August 2007

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1 Executive Summary

This document sets out for consultation National Grid NTS's proposals for amending the Gas Transmission Transportation Charging Methodology (the "Charging Methodology") in respect of the prevailing TO Over Recovery Mechanism. In the event of TO over recovery, the mechanism leads to a credit being paid to all Users based on their Monthly System Entry Capacity (MSEC) holdings and NTS Entry Capacity buy-back costs. NTS Entry Capacity buy-back costs represent a cost to Users via the Entry Capacity Neutrality charge.

From 1st October 2007 the TO Entry Commodity charge rate will be set at or close to zero as a result of the revenue implied by the 2007 AMSEC auction and forecast revenue for the remaining rolling monthly NTS Entry Capacity (RMSEC) auctions. Actual revenue resulting from the remaining RMSEC auctions (and potentially revenue resulting from the Entry Capacity Trade & Transfer processes proposed to be introduced through UNC Modification Proposals 0156, 0156a or 0163) may result in TO Entry over recovery.

The prevailing TO over recovery mechanism may result in credits being less than both the buy back costs and the revenue over recovery in the formula year hence the process may be inefficient in redistributing excess revenue. This is largely due to the over recovery amount being divided by the remaining months within the formula period and the fact that credits are only paid against buy-back costs that occur during or after the month in which over recovery has been identified. Buy-back costs from earlier in the formula year but prior to over-recovery being identified might not be included; for example auction revenue might not imply over recovery until February but we may have incurred buy-back costs in the months up to January.

GCM09: National Grid NTS proposes through this consultation document that:

Trigger

- The TO over-recovery mechanism would be triggered if the revenue implied by NTS Entry Capacity auctions breached either the Licence obligation not to exceed the maximum NTS transportation owner revenue (TOMR_t) by more than 4% in any formula year or not to exceed the maximum NTS transportation owner revenue by more than 6% over any two consecutive formula years

- The process would be triggered at any point during the formula year based on the outcome of any NTS Entry Capacity auction other than the on the day auctions for daily capacity (DSEC) and daily interruptible capacity (DISEC).

Mechanism

- The full over recovery amount would be available in relation to the first month for which the mechanism was triggered

- The credit would offset buy-back costs and hence Daily capacity & over-run revenue could represent an additional credit

- Any residual over recovery at the end of a month would be rolled forward to the next month

- Any residual over recovery at the end of the formula year would be used to offset buy backs costs in those months within the formula period when buy-back costs had occurred and no credit had been paid or where the credit was less than the buy-back cost

Implementation

It is proposed that these arrangements are implemented to define the TO Over Recovery Mechanism from 1st November 2007.

Future Proposals

This proposal represents an incremental change to the prevailing over-recovery methodology. The proposal may not, in practice, redistribute the full over recovery amount as buy-back costs may be less than the over recovery amount. National Grid NTS will further investigate other options including the potential for introducing a negative TO Entry Commodity charge in order to reduce the risk of over recovery and will bring forward separate proposals as required.

The closing date for submission of your responses to this consultation is **Friday 14th September 2007**.

2 Introduction

- 2.1 The TO Entry Commodity charge rate will be set at or close to zero as a result of the revenue implied by the 2007 AMSEC auction.
- 2.2 Revenue resulting from the RMSEC auctions (and potentially the Entry Capacity Trade & Transfer processes proposed through UNC Modification Proposal 0156) may result in TO revenue over recovery.
- 2.3 Entry and Exit TO revenue are managed separately and TO charges are set such that 50% of TO allowed revenue, other than that revenue collected through the DN Pensions charge, is collected 50% from Entry and 50% from Exit.
- 2.4 TO Exit Capacity charges are based on administered prices which are designed to collect all TO Exit allowed revenue. TO Entry Capacity charges are based on pay-as-bid auctions and any under recovery is managed by setting the TO Entry commodity charge.
- 2.5 The TO Entry Commodity charge cannot currently be used as an over recovery mechanism for Entry over-recovery and hence the TO Entry Commodity price cannot be set to have a negative value. The TO Entry over recovery mechanism is based on paying credits which offset entry capacity buy-back costs, as explained in section 3.
- 2.6 The following table outlines the history of the development of the TO over and under recovery mechanisms. The table gives the relevant Pricing Consultation paper number and title along with a brief summary of the proposal and the Authority decision.

Number	Title	Proposal	Decision
PC65	Alternative Methods of Funding Entry Capacity Constraint Management	If auction implied revenue is more than 10% above the target TO allowable revenue, this excess is divided into monthly amounts and is used to pay a credit which offsets the capacity neutrality entry capacity buy-back costs	Not vetoed
PC66	Transportation Charge adjustment following Entry Capacity Auctions	Any under recovery would be accounted for through the generality of transportation charges rather than just the NTS Commodity charge	Not vetoed
PC67	Technical Adjustment to PC65 Mechanism	Technical adjustment that allowed the credit to be greater than the entry charges paid by an individual shipper	Not vetoed
PC75	NTS TO Commodity Charge	Introduction of an NTS TO Commodity charge (that may be negative) to supersede PC65 (compliment PC65 in final proposal)	Vetoed
PD17	Setting of NTS Transportation Charges	Consideration of whether the charging methodology is consistent with auction uncertainty	N/A
PC77	NTS TO Commodity Charge	Introduction of an NTS TO Commodity charge (that may be negative) as the primary over/under recovery mechanism with PC65/67 as the secondary mechanism	Vetoed
PC78	NTS TO Commodity Charge (NTS TO Under Recovery)	Introduction of an NTS TO commodity charge as a mechanism for dealing with the under recovery of NTS TO revenue only.	Not vetoed

3 Prevailing Methodology

- 3.1 If entry capacity auction implied revenue is anticipated to be more than 10% above the target auction revenue¹, the total excess auction revenue is divided into monthly amounts and is used to 'fund' the entry buy-back scheme.
- 3.2 This is achieved by way of credits (a reduction in entry capacity charges) for each month by the lower of the monthly excess and monthly buy-back cost.
- 3.3 These credits offset the costs of entry capacity buy-back that are borne by shippers through the capacity neutrality mechanism. The credits would be treated as payments to shippers under the Licence TORCOM_t term.
- 3.4 Any excess amount (of auction revenue) remaining for any month is carried forward to the next month.
- 3.5 Any excess amount (of auction revenue) remaining at the end of the formula period would feed into the 'K' mechanism. Excess revenue from one formula period results in reduced allowed revenue in the following formula period.

Pricing Consultations PC65 PC67

- 3.6 The entry capacity buy-back offset mechanism was introduced in 2001 as a result of Pricing Consultation PC65. PC65 amended the transportation charging methodology such that :
 - If auction implied revenue is above, but within 10% of, the target level, there will be no automatic offsetting adjustment to transportation charges;
 - If auction implied revenue is more than 10% above the target level, National Grid NTS will calculate the level of this excess revenue;
 - The excess revenue will then be divided by six² in order to establish monthly amounts;
 - For any month where the excess amount exceeds aggregate User buy-back costs, the excess amount for the following month will be increased by the amount by which the excess exceeds aggregate User buy-back costs; and
 - National Grid NTS will reduce each User's entry capacity charges by a share of the lower of the excess or buy-back costs for the relevant month, with that share based on the proportion of aggregate MSEC held by the User concerned in the relevant month, subject to that share not exceeding its unadjusted entry charge.
- 3.7 Pricing consultation PC67 resulted in the removal of the rule "*subject to that share not exceeding its unadjusted entry charge.*"

¹ Target Entry Capacity auction revenue is currently 50% of the TO allowed revenue remaining after DN pension charges have been deducted.

² At the time that PC65 was implemented, the mechanism would have been applied in the October with the knowledge of previous auction results.

4 Discussion and Issues

- 4.1 From 1st October 2007 the TO Entry Commodity charge rate will be set at or close to zero as a result of the revenue implied by the 2007 AMSEC auction and forecast revenue for the remaining rolling monthly NTS Entry Capacity (RMSEC) auctions. Actual revenue resulting from the remaining RMSEC auctions (and potentially revenue resulting from the Entry Capacity Trade & Transfer processes that might be introduced through UNC Modification Proposals 0156, 0156a or 163) may result in TO Entry over recovery.

Issues Regarding the Prevailing TO Over Recovery Mechanism

- 4.2 The prevailing TO over recovery mechanism may result in credits being less than both the buy back costs and the revenue over recovery in the period hence the process may be inefficient in redistributing excess revenue. This is largely due to the over recovery amount being divided by the remaining months within the formula period and the fact that credits are only paid against buy-back costs that occurred during or after the month in which over recovery has been identified. Buy-back costs from earlier in the formula year but prior to over-recovery being identified might not be included. E.g. what if buy back costs are high in January but we do not over recover until February?
- 4.3 The full over recovery amount could be available in the first month rather than dividing by the number of remaining months. Credits could also be made in relation to any buy-back costs incurred earlier within the formula year. These changes would increase the likelihood of credits being paid.
- 4.4 The prevailing methodology generates a credit up to the net buy-back cost. The net buy-back cost is the entry capacity neutrality cost which equates to the buy-back cost less daily capacity revenue and entry capacity over-run revenue. Limiting the credit to net buy-back costs might therefore limit the credit, and therefore limit the effectiveness of the mechanism, when there are daily capacity and or over-run revenues. Given that entry capacity neutrality can represent a credit to Users for days when there is daily capacity revenue and or entry capacity over-run revenue, it seems reasonable not to reduce the buy back offset mechanism credit based on these revenues.
- 4.5 The Charging Methodology is unclear as to what happens if TO revenue over recovery is triggered by the RMSEC or any other auctions that may be introduced. This area of the Charging Methodology has not been revised since 2001 and hence an update based on revisions to the capacity regime over the intervening years should provide clarity and hence improve transparency.
- 4.6 Even if changes are made to the buy-back offset mechanism, there remains a risk that buy-back costs are less than the over recovery amount and hence the mechanism will not redistribute the full over recovery amount. In this scenario, excess revenue would flow into the 'K' mechanism. Excess revenue from one formula period result in reduced allowed revenue in the following formula period. This may lead to excess revenue collected from Entry Users being effectively redistributed on a fifty-fifty basis between Entry and Exit Users in the following formula period.

TO Entry Commodity Charge

- 4.7 Proposals have been raised in the past to introduce a negative TO Commodity charge to manage over recovery firstly to compliment the buy-back offset mechanism and secondly as a primary over recovery mechanism but both proposals were vetoed by the Authority. The difficulty with a negative commodity charge in combination with the buy-back offset mechanism is that both buy-back costs and over recovery revenue must be forecast to set the commodity rate and this is far from a simple or transparent process.
- 4.8 Even if appropriate forecasting processes could be defined there remains the scenario that over recovery is triggered at a time that does not allow a negative rate to be set within the formula year given the charge notice requirements within the Licence and the UNC.
- 4.9 The proposed amendment, contained within this consultation document, in respect of the TO Over Recovery Mechanism may not in practice redistribute the full over recovery amount (4.6 above). National Grid NTS will further investigate other options including the potential for introducing a negative TO Entry Commodity charge in order to reduce the risk of over recovery and will bring forward separate proposals.
- 4.10 The TO Entry Commodity charge has been set at a non-zero rate for the period April 2007 to September 2007. National Grid NTS recognise that the risk of TO over-recovery might be mitigated by setting a zero rate TO Commodity charge for the first six months of the formula period and hence will consider a return to charging for the winter period only.

Mechanism Trigger

- 4.11 The entry capacity buy-back offset mechanism is not triggered until over recovery is in excess of 10% of allowed revenue. This is not consistent with the National Grid Gas Transportation Licence in respect of the NTS which includes reasonable endeavours obligations not to over recover by more than 4% in any formula year and not to over recover by more than 6% over any two consecutive formula years.
- 4.12 The process could be triggered at any point during the formula year based on the outcome of any auction representing a TO revenue stream. Revenue from on the day auctions is treated as SO revenue.

5 National Grid NTS's Proposal

5.1 National Grid NTS proposes that:

Trigger

- The mechanism would be triggered if the revenue implied by NTS Entry Capacity auctions breached either the Licence obligation not to exceed the maximum NTS transportation owner revenue (TOMR_i) by more than 4% in any formula year or not to exceed the maximum NTS transportation owner revenue by more than 6% over any two formula years
- The process would be triggered at any point during the formula year based on the outcome of any NTS Entry Capacity auction other than the on the day auctions for daily capacity (DSEC) and daily interruptible capacity (DISEC).

Mechanism

- The full over recovery amount would be available in relation to the first month for which the mechanism was triggered
- Any residual over recovery at the end of the month would be rolled forward to the next month.
- Any residual over recovery at the end of the formula year would be used to offset buy backs costs in those months within the formula period when buy-back costs had occurred and no credit had been paid or where the credit was less than the buy-back cost (Un-credited buy-back costs)
 - Where the residual over recovery is less than the aggregate un-credited buy-back costs,
 - Credits would be calculated for each month in proportion to the un-credited buy-back costs in each month.
 - Where the residual over recovery is equal to or greater than the aggregate un-credited buy-back costs,
 - Credits would be calculated for each month equal to the un-credited buy-back costs in each month.
- The credit would offset buy-back costs and hence Daily capacity & over-run revenue could represent an additional credit through capacity neutrality

Implementation

5.2 It is proposed that these arrangements are implemented to define the TO Over Recovery Mechanism from 1st November 2007.

5.3 Credits would be paid following the month of over recovery.

6 Justification

Assessment against Licence Objectives

- 6.1 The National Grid plc Gas Transporter Licence in respect of the NTS 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 NTS believes that the proposal contained in this paper would satisfy the relevant objectives as, in improving the efficiency of the process, the likelihood of over recovery is reduced and hence the aggregate charges would more closely reflect the costs incurred within the formula year.
- 6.4 The proposal modifies the TO Over-recovery mechanism to take into account past and potential future changes to the NTS Entry Capacity regime and hence “takes into account developments in the transportation business”.
- 6.5 The proposal retains the principle that credits are paid in relation to capacity holdings and hence capacity revenue is returned to capacity holders without creating an incentive to procure more capacity than might otherwise have been the case.
- 6.6 The proposal will ensure that where over-recovery occurs within a month, due to the RMSEC auction, the over recovery will first offset buy-back costs in that month before being used to offset buy-back costs at other times in the formula year.

Assessment against EU Gas Regulations

6.7 EC Regulation 1775/2005 on conditions for access to the natural gas transmission networks (binding from 1 July 2006) states that 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.

6.8 National Grid NTS believes that its charging proposal put forward in this paper is consistent with the principles listed above, specifically the amended methodology should;

- Be transparent
- Reflect actual costs incurred for an efficient and structurally comparable network operator
- Be applied in a non-discriminatory manner
- Avoid cross-subsidies between network users
- Not restrict market liquidity
- Not distort trade across borders of different transmission systems.

7 Questions for Consultation

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

Trigger

- The mechanism trigger is linked to National Grid NTS's obligation not to exceed the maximum NTS transportation owner revenue ($TOMR_t$) by more than 4% in any year and not to exceed the maximum NTS transportation owner revenue by more than 6% over any two consecutive formula years
- Process would be triggered at any point during the formula year

Mechanism

- The full over recovery amount would be available in the first month of over recovery
- Credits would be paid based on monthly buy-back costs rather than 'net buy-back costs' (buy-back costs less over-run and daily capacity revenue) with daily capacity and over-run revenue potentially representing an additional credit
- Any remaining excess revenue would be rolled forward to the next month
- Any remaining excess revenue at the end of the formula year would fund retrospective credits to offset buy-back costs earlier in the formula year

The closing date for submission of your responses is **Friday 14th September 2007**. Your response should be e-mailed to:

box.transmissioncapacityandcharging@uk.ngrid.com.

or alternatively sent by post to

Eddie Blackburn, Regulatory Frameworks, National Grid, National Grid House, Gallows Hill, Warwick, CV34 6DA.

If you wish to discuss any matter relating to this charge methodology consultation then please call Eddie Blackburn ☎ 01926 656022 or DebraHawkin ☎ 01926 656317.

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

Appendix A – Examples

Example 1

This example assumes that over recovery is identified in October and there are no buy-back costs before October.

	All figures in £m		Oct	Nov	Dec	Jan	Feb	Mar	Total
A	Excess revenue from earlier auctions	A, data	£16.20						£16.20
B	RMSEC excess revenue for month	B, data	£0.00	£1.00	£2.00	£1.00	£2.00	£2.00	£8.00
C	Excess b/f from previous month	E=H from previous month		£14.20	£11.20	£0.00	£0.00	£0.00	
D	Max rebate level for month	D= A+B+C	£16.20	£15.20	£13.20	£1.00	£2.00	£2.00	
E	Buy-back costs in month	E, data	£2.00	£4.00	£15.00	£2.00	£3.00	£1.00	£27.00
F	Credit for Month	F = Min(D,E)	£2.00	£4.00	£13.20	£1.00	£2.00	£1.00	£23.20
G	Un-credited buy-back cost	G=E-F	£0.00	£0.00	£1.80	£1.00	£1.00	£0.00	£3.80
H	Potential credit carried forward	H=D-F	£14.20	£11.20	£0.00	£0.00	£0.00	£1.00	
J	Additional retrospective Credit	Pro-rata H from March based on G	£0.00	£0.00	£0.47	£0.26	£0.26	£0.00	£1.00

Example 2

This example assumes that over recovery is identified in January and there are no buy-back costs before October however there are buy back costs prior to over recovery being identified.

	All figures in £m		Oct	Nov	Dec	Jan	Feb	Mar	Total
A	Excess revenue from earlier auctions	A, data				£0.00			£0.00
B	RMSEC excess revenue for month	B, data				£3.00	£4.00	£2.00	£9.00
C	Excess b/f from previous month	E=H from previous month				£0.00	£1.00	£2.00	
D	Max rebate level for month	D= A+B+C				£3.00	£5.00	£4.00	
E	Buy-back costs in month	E, data	£2.00	£4.00	£15.00	£2.00	£3.00	£1.00	£27.00
F	Credit for Month	F = Min(D,E)				£2.00	£3.00	£1.00	£6.00
G	Un-credited buy-back cost	G=E-F	£2.00	£4.00	£15.00	£0.00	£0.00	£0.00	£21.00
H	Potential credit carried forward	H=D-F	£0.00	£0.00	£0.00	£1.00	£2.00	£3.00	
J	Additional retrospective Credit	Pro-rata H from March based on G	£0.29	£0.57	£2.14	£0.00	£0.00	£0.00	£3.00