Gas network operators: gas shippers; their customers and any other interested parties

Promoting choice and value for all gas and electricity customers

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Direction approving a one-off change in the level of NTS exit capacity charges to be effective from 1 April 2013

On 14 January 2013 National Grid Gas Transmission ("NGGT") published an open letter[1] seeking a direction[2] from us[3] to permit a one-off change to the level of NTS Exit Capacity charges ("exit charges") with effect from 1 April 2013. Under its licence[4] NGGT is required not to change exit charges more than once in each year, and for that change to take place on 1 October, unless otherwise approved by us. In its letter NGGT sets out its view that implementing a one-off change to the level of exit charges from 1 April 2013 will reduce the level of volatility in exit charges it forecasts over the next three years.

This letter summarises the issues associated with the proposed change, and explains our decision to consent to the proposed change.

Background and NGGT's consultation paper 'NTS GCD10'[5]

Exit charges are conventionally set annually to align with the 'gas year'[6] running from 1 October to 30 September. However, under its Transmission Owner ("TO") price control, the regulated revenue that NGGT is allowed to recover from users of the National Transmission System ("NTS") is determined in accordance with the price control formula year (the "formula year") which runs from 1 April to 31 March. Exit charges (and entry charges) are levied on NTS users by NGGT in order to recover its allowed revenue, and it is incentivised under its licence to recover this revenue as accurately as possible within the formula year.

The misalignment between the formula year and the gas year has been identified as a contributing factor to the volatility of exit charges. Because NGGT needs to set exit charges to recover its target allowed revenue, where it under or over recovers during the first six months of a formula year, it must compensate for this during the second half of the

[1] '*Open Letter – Request for a direction from the Authority to change NTS Exit Capacity charges to be effective 1 April 2013*'. A copy of this letter and other documentation relating to the proposed charging change including responses to NGGT's industry consultation are available on NGGT's website at the following location http://www.nationalgrid.com/uk/Gas/Charges/consultations/Current+Discussion+Papers/
[2] under Standard Special Condition A4 (Charging General) of its Gas Transporter Licence (the "Licence")
[3] The terms "Authority", "Ofgem", "we" and "our" are used interchangeably in this letter.
[4] Paragraph 2(a)(ii) of Standard Special Condition A4 of the Licence only permits changes to charges once in each formula year on 1 October unless a written direction from the Authority has been published stating that the change can take place on another date.
[5] '*NTS GCD10: Potential one-off change to TO NTS Exit (Flat) Capacity Charges for April 2013'.* This paper was published by NGGT on 24 October 2012. A copy of the consultation is available to view on NGGT's website.
[6] In the gas industry the 'gas year' runs from 1 October. This is the date when contracts concerning the wholesale trading of gas can be renewed or take effect.

formula year. This can result in significant year on year changes to the level of exit charges.

The effect of the misalignment of the formula year and the gas year has been known for some time, and following publication of our October 2012 decision[7] on measures to mitigate network charging volatility arising from the price control settlement, NGGT has undertaken to review the timing of the annual change in the level of exit charges ahead of 2014. However, during 2012, NGGT identified a concern that the effect of the misalignment, in combination with the potential change in allowed revenues associated with the implementation of RIIO-T1 from 1 April 2013, could introduce additional volatility to the level of exit charges forecast between 1 October 2013 and 1 October 2015.

To address these concerns, in October 2012, NGGT published a consultation paper 'NTS GCD10' which sought industry views on the option of implementing a one-off change to the level of exit charges in April 2013 as a way of reducing charging volatility. In its consultation paper, NGGT modelled the impact of the one-off change relative to the status quo (October 2013 change only) using forecast allowed revenues from its 2012 RIIO-T1 business plan submission, and from our RIIO-T1 Initial Proposals ("IP") document. Under both scenarios the modelling showed that forecast charging volatility would be greater between 1 October 2013 and 1 October 2015 apart from the one-off April 2013 change. However the level of volatility forecast would be lower, and therefore the benefits of the change less emphatic, under our IP assumptions.[8]

NGGT received nine responses to its industry consultation. A majority of the responses indicated support for the one-off change under both scenarios. One respondent considered that the change would only be justified if allowed revenues under Final Proposals ("FP") for RIIO-T1 closely aligned to NGGT's business plan. Two gas shipper respondents considered that the notice period for the change was too short and would not allow sufficient time for businesses to adjust.

Following the consultation, NGGT published an open letter and a report summarising respondents' views and its findings. In the letter NGGT said that it remained appropriate to implement the April 2013 change and that it would write to us in early January 2013 seeking a direction to permit the change. As part of its open letter, NGGT stated that it would provide further price analysis based on the RIIO-T1 FP. NGGT has provided this analysis in the two appendices supporting its letter to the Authority of 14 January 2013.

The Authority's view and decision

We have considered NGGT's request in accordance with our principal objective and statutory duties and in view of the information submitted by NGGT. We understand the importance of stable and predictable network charges to gas and electricity network customers. For this reason, while taking other charging methodology objectives into consideration, we support initiatives aimed at reducing network charging volatility. In our view NGGT's proposed one-off change in April 2013 to the level of exit charges can be expected, to the extent that its charging forecasts are accurate,[9] to reduce the level of volatility in exit charges between April 2013 and October 2015.

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[7] '*Decision on measures to mitigate network charging volatility arising from the price control settlement*', Ofgem, 17 October 2012. The decision includes increased onus on information provision; restriction on intra-year charging changes; and decision to lag revenue impact of incentive penalty/rewards by two years.

[8] Absent the one-off April change, Chart 3.2 of NGGT's 'NTS GCD10' document forecasts the average level of exit charges will fluctuate between approximately 0.0115 p/pdkwh/day and 0.0200 p/pdkwh/day between October 2013 and October 2015 under its 2012 business plan allowed revenue assumptions. This compares to a fluctuation of between just under 0.0100 p/pdkwh/day and approximately 0.0130 p/pdkwh/day under Ofgem's RIIO-T1 Initial Proposals allowed revenue assumptions.

[9] Chart 1 of Appendix A of NGGT''s 14 January 2013 letter forecasts that by implementing the one-off April change the average level of exit charges will fluctuate between just over 0.0100 p/pdkwh/day and approximately 0.0110 p/pdkwh/day between April 2013 and October 2015. This compares to between slightly more than 0.0080 p/pdkwh/day and slightly above 0.0125 p/pdkwh/day absent the proposal.

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Following publication of RIIO-T1 FP,[10] it is clear that NGGT's allowed revenues from 1 April 2013 will be[11] significantly closer to RIIO-T1 IP allowed revenues than the revenues it forecast in its business plan. Based on the evidence presented in NGGT's consultation, this would suggest that the benefit of implementing the proposal, in terms of the avoided charging volatility, may be less emphatic than it would have been under its business plan proposals.

In our view, the benefit of reduced charging volatility stands under each of the revenue scenarios considered in NGGT's consultation, and for this reason we consent to the implementation of the change to be effective from 1 April 2013. We note that Appendix A of NGGT's 14 January letter indicates that, based on its analysis of the allowed revenue impacts of RIIO-T1 FP, forecast charging volatility, absent the proposal, would be greater under FP than that forecast for IP. In our view this information lends further support for the change.

In reaching our decision, we have taken account of the views on the implementation of the proposal of gas shippers during the consultation. We have also considered the views of the respondent who considered that the proposal should not be implemented if allowed revenues under FP were similar to IP.

We agree that the notice period for the change is short. However we consider that two factors mitigate this concern. Firstly the effect of the change is an absolute reduction[12] in the level of exit charges for all network users other than those already on the minimum charging levels. Secondly, because the change does not concern the charging methodology itself, there are no significant distributional effects (otherwise known as 'winners and losers'). We note that at the January 2013 meeting of the NTS Charging Methodology Forum,[13] this point was accepted by both respondents as potentially mitigating their concerns. As noted above, we consider that the benefit of reduced charging volatility stands under each of the revenue scenarios.

We have also considered the impact of the proposal on consumers and other gas customers, and we note that, as the proposal does not affect NGGT's allowed revenues, there is no direct impact on consumers. The proposal should result in more stable exit charges over the next two years, but it will not affect the aggregate level of the charges levied. A proportion of exit charges are recovered by the Gas Distribution Networks ("GDNs") directly from their customers via the Local Distribution Zone (LDZ) Exit Capacity NTS ("ECN") charge. Following implementation of the proposal, the GDNs may seek to update their charging statements to take account of the revised exit charges which will apply from 1 April 2013. Since the effect will be a reduction in ECN charges, we do not anticipate negative consequences for the GDNs or their customers should they choose to do this, and we note that no such consequences were identified by the GDNs during the consultation.

This letter constitutes notice pursuant to section 38A of the Gas Act 1986.

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[10] *RIIO-T1: Final Proposals for National Grid Electricity Transmission and National Grid Gas',* Ofgem, 17 December 2012. A copy of this document and its associated documents is available to view at the following location on our website: http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?file=1_RIIOT1_FP_overview_dec12.pdf&refer=Networks/Trans/PriceControls/RIIO-T1/ConRes

[11] At the time of publishing this letter NGGT has not announced a decision on whether to accept RIIO-T1 Final Proposals, however we note the proposed one-off April change in the level of exit charges will not be affected by this decision.

[12] Appendix Two of NGGT's 14 January 2013 letter indicates that from 1 April 2013 there will be a reduction in exit charges of approximately 0.0020 p/pdkwh/day for all NTS exit points other than those already on the minimum or close to the minimum exit charge.

[13] The NTS Charging Methodology Forum is used by NGGT and industry stakeholders to discuss issues affecting NTS charges and NTS charging methodologies. More information about the meeting can be found at the following link: http://www.gasgovernance.co.uk/ntscmf/2013

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If you have any questions concerning this decision, please contact James Thomson on 0141 331 6012 (James.Thomson@ofgem.gov.uk)

Yours sincerely

Andrew Burgess

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Signed on behalf of the Authority and authorised for that purpose.

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