

## Stage 03: Draft Modification Report

# 0459S:

## Amendments to the 'K' revenue adjustment factor based on RIIO-T1

This modification proposes changes to the 'K' revenue adjustment factor calculation based on amendments in RIIO-T1.



Responses invited by 11 July 2013.



High Impact: -



Medium Impact: -



Low Impact: National Grid Transmission, Gas Distribution Network Operators, Shippers and Suppliers

At what stage is this document in the process?



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## About this document:

This Draft Modification Report is issued for consultation responses, at the request of the Panel on 20 June 2013. All parties are invited to consider whether they wish to submit views regarding this self-governance modification.

The close-out date for responses is 11 July 2013, which should be sent to [enquiries@gasgovernance.co.uk](mailto:enquiries@gasgovernance.co.uk). A response template, which you may wish to use, is at [www.gasgovernance.co.uk/0459](http://www.gasgovernance.co.uk/0459).

The Panel will consider the responses and agree whether or not this self-governance modification should be made.



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# 1 Summary

## Is this a Self-Governance Modification?

The Modification Panel determined that this is a self-governance modification.

## Why Change?

The Maximum NTS Transportation Owner (TO) Revenue, defined in the Gas Transporter Licence in respect of the NTS (the "Licence") determines the Allowed Revenue to be recovered in any given financial year and contains a term referred to as 'K<sub>t</sub>'. This 'K<sub>t</sub>' term is the correction term for revenue adjustment representing the under or over recovery of overall TO charges from a previous year, and it includes interest applied based on the amount of under or over recovery of TO Revenue collected against the NTS TO Maximum Allowed Revenue. There are some changes to the calculation of 'K<sub>t</sub>' that, as part of implementing RIIO-T1, need to be accommodated within the Charging Methodology contained in the UNC TPD Section Y.

In formula year 2013/2014 the calculation of 'K' is a continuation of the arrangements in the TPCR4 price control period and in formula year 2015/2016 onwards 'K<sub>t</sub>' will be calculated based on the new RIIO 'K<sub>t</sub>' calculation. In formula year 2014/2015 the value of 'K<sub>t</sub>' will be zero. Formula year 2015/2016 will be the first year for the new calculation to be used because in 2015/2016 the calculation will be able to take into account the figures for the two year lag on the collected revenue.

It is necessary to amend the UNC to reflect this change, so that terminology in the UNC, and the UNC cross references to the Licence, remain correct.

## Solution

This Modification proposes amendments to UNC TPD Section Y so that the UNC correctly reflects changes in terminology due to RIIO-T1 and cross-refers correctly to the revised NTS GT Licence conditions.

It is proposed that changes are made to Appendix A – Treatment Of Under/Over Recovery 'K' within the UNC TPD Section Y, to change the calculation in accordance with the Licence.

## Relevant Objectives

Implementation of this Modification Proposal would facilitate the following Relevant Objectives:

- a) Save in so far as paragraphs (aa) or (d) apply, that compliance with the charging methodology results in charges which reflect the costs incurred by the licensee in its transportation business;
- b) That, so far as is consistent with sub-paragraph (a), the charging methodology properly takes account of developments in the transportation business;

## Implementation

As Self-Governance procedures are proposed, implementation could be sixteen business days after a Panel decision to implement (subject to no Appeal being raised).

## 2 Why Change?

On 27 July 2012 Ofgem published 'RIIO-T1 and GD1: Draft licence conditions – First Informal Licence Drafting Consultation'. That document contemplates changes to the National Transmission System (NTS) Gas Transporter Licence. The changes are required in order for the licence to be consistent with the outcome of the RIIO (Revenue = Incentives + Innovation + Outputs) regulatory framework. Within the same document, Ofgem also proposes to update/consolidate a number of existing NTS licence conditions. However, it did not specify all of the new licence condition numbering, but rather identified which sections of the licences will be subject to change. Ofgem published a Second Informal Licence Drafting Consultation, containing further condition numbering, on 31 October 2012.

Ofgem completed final licence drafting and condition numbering on 21 December 2012. This was incorporated within the statutory licence modification consultation required to implement Ofgem's Final Proposals.

Under RIIO-T1 there are two changes to the ' $K_t$ ' term that will need to be reflected in Section Y of the UNC to ensure the correct value is included in the calculation of transportation Charges:

1. A move to a two year lag from a one year lag; and
2. New interest rate calculations to be applied on the under or over recovery.

This UNC modification seeks to update the calculation of the 'K' revenue adjustment factor based on the two year lag and changes to calculation of interest to be consistent with the updates to the Licence as a result of implementing of the new RIIO regulatory framework. The term Penalty Interest Rate under RIIO-T1 changes to be referred to as the Interest Rate Adjustment.

In formula year 2013/2014 the calculation of 'K' is a continuation of the arrangements in the TPCR4 price control period and will use the existing methodology of calculating ' $K_t$ '. In formula year 2015/2016 onwards ' $K_t$ ' will be calculated based on the new calculation for the RIIO price control. In formula year 2014/2015 the value of ' $K_t$ ' will be zero. Formula year 2015/2016 will be the first year the new calculation will be used as this will reflect the over or under recovery for revenue collected for formula year 2013/2014 and applying the two year lag for adjustments introduced under RIIO-T1.

These amendments are applicable from 2014/2015 onwards in the National Grid Transmission Transportation Charging Methodology contained in UNC TPD Section Y - Appendix A – Treatment Of Under/Over Recovery 'K'. It is necessary to amend the UNC – Section Y to reflect this change, so that terminology in the UNC, the UNC cross references to the licence, remain correct and ensure the calculation of the transportation charges is correct.

The current Penalty Interest Rate ( $PR_t$ ) values (also applicable in first year of RIIO - 2013/2014) are:

- Revenue collected exceeds maximum TO Revenue then  $PR_t$  has the value of 3
- Revenue collected does not exceed maximum TO Revenue then  $PR_t$  has the value of 0

New Interest Rate Adjustment ( $PR_t$ ) values under RIIO (applicable from 2014/2015 onwards):

- Revenue collected exceeds 104% of maximum TO Revenue then  $PR_t$  has the value of 3
- Revenue collected is between 96% and 104% of maximum TO Revenue then  $PR_t$  has the value of 1.5

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- Revenue collected is less than 96% of maximum TO Revenue then  $PR_t$  has the value of 0  
In the formula year 2014/2015 ' $K_t$ ' will have the value of zero.

### 3 Solution

It is proposed to amend UNC – Section Y to ensure that terminology in the Charging Methodology, and references within the UNC to the NTS GT Licence, are aligned with the changes introduced by the RIIO T1 price control outcome. This Modification proposes amendments to the UNC so that the UNC correctly reflects changes in terminology due to RIIO-T1, cross-refers correctly to the revised NTS GT licence conditions and reflects changes to the calculation introduced by RIIO-T1.

The required changes will be to Appendix A – Treatment Of Under/Over Recovery 'K' within the UNC TPD Section Y. For the formula year 2013/2014 calculation of 'K' is a continuation of the arrangements in the TPCR4 price control period having a one year lag and for formula year 2014/2015 onwards the value for ' $K_t$ ' will be calculated based on the new RIIO K revenue adjustment factor calculation, but for 2014/2015 formula year the value of ' $K_t$ ' is zero.

The calculation will be amended, to align with the licence and ensure the calculation of the transportation charges are correct, using the following:

New Interest Rate Adjustment ( $PR_t$ ) values under RIIO, which are applicable from 2014/2015 onwards:

- Revenue collected exceeds 104% of maximum TO Revenue then  $PR_t$  has the value of 3
- Revenue collected is between 96% and 104% of maximum TO Revenue then  $PR_t$  has the value of 1.5
- Revenue collected is less than 96% of maximum TO Revenue then  $PR_t$  have the value of 0

It is proposed that the calculation of 'K' for formula year 2014/2015 onwards applies the interest rate adjustment based on the net revenue position. This is to ensure that the calculation is aligned with the Licence, it uses the same level of apportionment across Entry and Exit based on the net revenue position. The calculations take into account the net recovery position before splitting by exit and entry and the same interest rate adjustment percentage is applied to both the entry and exit portions of the net revenue to ensure the total value calculated in accordance with the Licence is included in the revenue used in the calculation of the Transportation charges.

From 2014/2015 formula year of the price control period the correction term for the NTS TO is calculated using a two year lag to the correction, not a one year lag as is currently specified in the TPCR4 price control, but for the 2014/2015 formula year the value of ' $K_t$ ' is zero as specified in the Licence. The one year lag and the existing interest rate banding and calculation will still be used for the 2013/2014 formula year, as the TPCR4 calculation will be used for this formula year.

The amendments to the calculation of ' $K_t$ ' to ensure it is in accordance with the licence and reflected in the transportation charges can be seen within the Legal Text section.

## User Pays

Classification of the modification as User Pays, or not, and the justification for such classification.

No changes are proposed to Xoserve systems or processes. Therefore this is not a User Pays Modification.

Identification of Users of the service, the proposed split of the recovery between Gas Transporters and Users for User Pays costs and the justification for such view.

Not applicable

Proposed charge(s) for application of User Pays charges to Shippers.

Not applicable

Proposed charge for inclusion in the Agency Charging Statement (ACS) – to be completed upon receipt of a cost estimate from Xoserve.

Not applicable

## 4 Relevant Objectives

| Impact of the modification on the Relevant Charging Methodology Objectives:   |                   |
|---|-------------------|
| Relevant Objective  | Identified impact |
| a) Save in so far as paragraphs (aa) or (d) apply, that compliance with the charging methodology results in charges which reflect the costs incurred by the licensee in its transportation business;  | Positive          |
| aa) That, in so far as prices in respect of transportation arrangements are established by auction, either: <ul style="list-style-type: none"> <li>(i) no reserve price is applied, or</li> <li>(ii) that reserve price is set at a level -               <ul style="list-style-type: none"> <li>(I) best calculated to promote efficiency and avoid undue preference in the supply of transportation services; and</li> <li>(II) best calculated to promote competition between gas suppliers and between gas shippers;</li> </ul> </li> </ul> | None              |
| b) That, so far as is consistent with sub-paragraph (a), the charging methodology properly takes account of developments in the transportation business;  | Positive          |
| c) That, so far as is consistent with sub-paragraphs (a) and (b), compliance with the charging methodology facilitates effective competition between gas shippers and between gas suppliers; and  | None              |
| d) That the charging methodology reflects any alternative arrangements put in place in accordance with a determination made by the Secretary of State under paragraph 2A(a) of Standard Special Condition A27 (Disposal of Assets).   | None              |
| e) Compliance with the Regulation and any relevant legally binding decisions of the European Commission and/or the Agency for the Co-operation of Energy Regulators.  | None              |

**a) Save in so far as paragraphs (aa) or (d) apply, that compliance with the charging methodology results in charges which reflect the costs incurred by the licensee in its transportation business;**  
 Some references to 'K<sub>t</sub>' revenue adjustment factors within the Licence conditions in the UNC will become obsolete or incorrect post the commencement of RIIO. This Modification will correct these references, and ensure the calculation of the transportation charges that reflect the costs incurred by the Licensee in its transportation business. The proposal also amends the way that the K calculation works within the UNC to bring it in line with the Licence.

**b) That, so far as is consistent with sub-paragraph (a), the charging methodology properly takes account of developments in the transportation business;**

This Modification proposes to align the references on 'K<sub>t</sub>' revenue adjustment factors in the UNC, with those in the Licence. By proposing to amend these references, this Modification takes account of developments in the transportation business through aligns the way that the K calculation works within the UNC to bring it in line with the Licence, allowing the Licence changes brought in by RIIO.

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## 5 Implementation

As self-governance procedures are proposed, implementation could be 16 business days after a Modification Panel decision to implement.

No implementation costs are anticipated.

## 6 Legal Text

### Text

#### APPENDIX A – TREATMENT OF UNDER/OVER RECOVERY 'K'

The following table defines the calculations used to calculate separate entry and exit K from the reported 'K<sub>t</sub>' term defined within the national Grid Licence in respect of the NTS.

| Net Position                 | Exit                | Entry                | Calculation   |
|------------------------------|---------------------|----------------------|---|
| Net Over Recovery            | Exit Over recovery  | Entry Under-recovery | $TOKEnt = (TOREnt_{t-1} - TOMAREnt_{t-1}) \times (1 + IR_t/100)$ $TOKEnt = TOK_t - TOKEnt$  |
|                              | Exit Under-recovery | Entry Over recovery  | $TOKEnt = (TOREnt_{t-1} - TOMAREnt_{t-1}) \times (1 + IR_t/100)$ $TOKEnt = TOK_t - TOKEnt$  |
|                              | Over-Recovery       |                      | $TOKEnt = (TOREnt_{t-1} - TOMAREnt_{t-1}) \times (1 + (IR_t + Pit)/100)$ $TOKEnt = (TOREnt_{t-1} - TOMAREnt_{t-1}) \times (1 + (IR_t + Pit)/100)$ |
| Net Under Recovery (or zero) | Exit Over recovery  | Entry Under-recovery | $TOKEnt = (TOREnt_{t-1} - TOMAREnt_{t-1}) \times (1 + IR_t/100)$ $TOKEnt = (TOREnt_{t-1} - TOMAREnt_{t-1}) \times (1 + IR_t/100)$                 |
|                              | Exit Under-recovery | Entry Over recovery  |   |
|                              | Under-Recovery      |                      |   |

#### Where

$TOK_{Ent} \sim$  TO Entry Revenue adjustment factor in respect of formula year t for charging purposes

$TORE_{Ent-1} \sim$  TO Entry Revenue collected in year t-1

$TOMARE_{Ent-1} \sim$  TO Maximum Allowed Revenue allocated to Entry in the Charging Methodology

$I_{Rt} \sim$  Percentage interest rate in respect of formula year t [Special Condition 2A of National Grid NTS's Transporters Licence]

$PI_{It} \sim$  Penalty interest rate in respect of formula year t [Special Condition 2A of National Grid NTS's Transporters Licence]

$TOK_{t} \sim$  Revenue adjustment factor in respect of formula year t [Special Condition 2A of National Grid NTS's Transporters Licence]

$TOK_{Ext} \sim$  TO Exit Revenue adjustment factor in respect of formula year t for charging purposes

$TORE_{Ext-1} \sim$  TO Exit Revenue collected in year t-1

$TOMARE_{Ext-1} \sim$  TO Maximum Allowed Revenue allocated to Exit in the Charging Methodology

| <u>Net Position</u>                      | <u>Interest Rate Adjustment (PR<sub>t</sub>)</u> | <u>Calculation</u>  |
|--|--|---|
| <u>Net Recovery &gt; 104%</u>            | <u>3%</u>  | <u><math>KEx_t = (TORE_{Ext-2} - MRE_{Ext-2}) \times (1 + (I_{t-2} + PR_t)/100) \times (1 + (I_{t-1} + 1.5)/100)</math></u> |
| <u>Net Recovery between 96% and 104%</u> | <u>1.5%</u>                                      | <u><math>KEn_t = (TORE_{Ent-2} - MRE_{Ent-2}) \times (1 + (I_{t-2} + PR_t)/100) \times (1 + (I_{t-1} + 1.5)/100)</math></u> |
| <u>Net Recovery &lt; 96%</u>             | <u>0%</u>  |   |

#### Where:

$KEn_t$ : TO Entry Revenue adjustment factor in respect of formula year t for charging purposes

$KEx_t$ : TO Exit Revenue adjustment factor in respect of formula year t for charging purposes

$TORE_{Ent-2}$ : TO Actual Revenue collected on Entry in year t-2

$TORE_{Ext-2}$ : TO Actual Revenue collected on Exit in year t-2

$MRE_{Ent-2}$ : TO Maximum Allowed Revenue allocated to Entry in the Charging Methodology in year t-2

$MRE_{Ext-2}$ : TO Maximum Allowed Revenue allocated to Exit in the Charging Methodology in year t-2

$I_t$ : Average Specified Rate in respect of formula year t

$PR_t$ : Interest Rate Adjustment in formula year t in accordance with Special Condition 2A of National Grid NTS's Transporter Licence

Net Recovery: TO Revenue as a percentage of Maximum Allowed Revenue (Special Condition 2A of National Grid NTS's Transporter Licence)

## 7 Recommendation

The Panel have recommended that this report is issued to consultation and all parties should consider whether they wish to submit views regarding this self-governance modification.

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