Modification 0356 Workgroup/ Transmission Charging Methodology Forum

Impact of under recovery from primary sale of capacity

Graham Jack
Asma Jalal

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Points to cover

- National Grid Allowed Revenue
- TO and SO Revenue
- Fixed (Capacity) and Variable (Commodity) charges
- Correction mechanisms
- Distortion of Charging Principles
- Causes of Under recovery
- Impact and increasing trend
- Conclusions

National Grid Allowed Revenue

- Allowed Revenue is set by Price Control
  - TPCR4, 2007 – 2012 (now extended to 2013)
  - TPCR5 (RIIO(T), 2013 – 2121
- Revenue is set by a return on assets plus incentives
- National Grid have a licence obligation to achieve this target revenue each year +/- a small margin
- Any Under or Over Recovery within a formula year is carried over to the next by “K” mechanism
- Price Control will determine both TO revenue and SO revenue

TO and SO Revenue

- TO & SO Charges are based on recovering Allowed Revenue during Formula Year (Apr – Mar)
- TO Allowed Revenue depends primarily on asset value and during TPCR4 increases by RPI each year.
- TO Allowed Revenue is allocated 50:50 across Entry:Exit. NB- Interruptible exit points do not pay capacity and the “lost” revenue is added to SO revenue.
- SO Allowed Revenue depends mainly on costs of operating the National Transmission System. Gas for shrinkage (compressor fuel, UAG) accounts for about 50% of this.
- There is opportunity to increase allowed revenue through incentives – capacity sales above baseline, and within day, and good operation.
- SO Allowed Revenue is also split 50:50 across Entry:Exit
- Storage connection points do not pay SO nor TO entry commodity charge.

Fixed (Capacity) and Variable (Commodity) charges

- Standard convention has been that Capacity related charges are driven by the cost of providing the asset.
- These are mainly recovered via a fixed cost for <u>holding</u> capacity and therefore the <u>ability</u> to transport gas
- In Contrast
- Commodity costs are charged as a variable cost, directly related to the <u>quantity</u> of gas that is transported

Correction mechanisms - Entry

- Entry capacity auctions may not recover the exact allowed entry revenue.
- If a shortfall in revenue is anticipated then a TO Entry Commodity charge is applied to recover the shortfall.
- If there is an over-recovery then this is put into a ‘buyback fund’, not refunded via a negative TO Commodity charge
- If there is an over-recovery at year end then if possible this is refunded through reducing the revenue collected through the TO Entry Commodity charge
- If there is still an over-recovery then this passes through to adjust TO charges for the following year (K)

Distortion of Charging Principles

- From the above, it can be seen that there is an intended structure between
  - capacity and commodity charges and
  - TO and SO revenues
- Broadly
  - Capacity revenues are TO related
  - Commodity revenues are SO related
- The TO Commodity charge breaches this structure and creates a situation where assets are funded by throughput charges

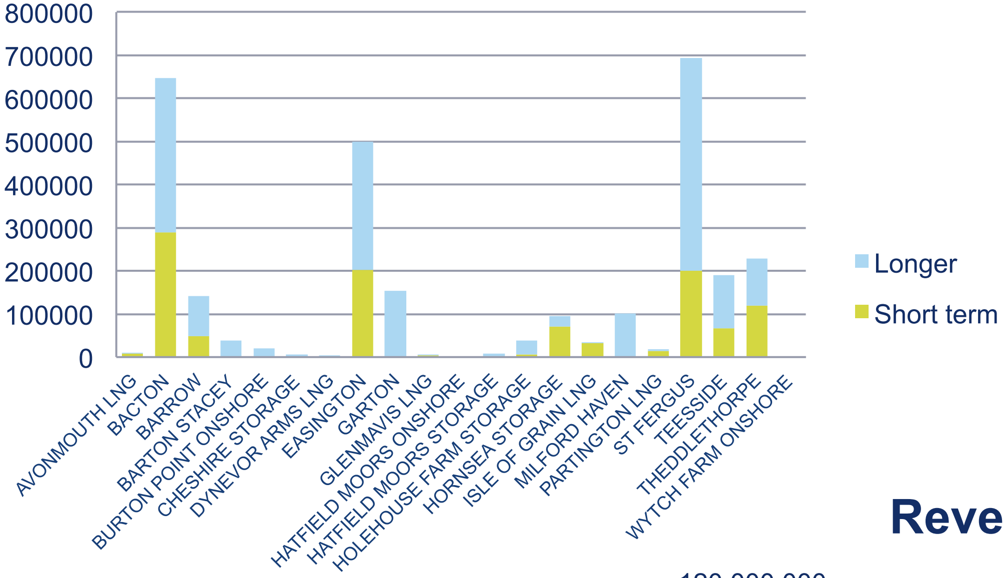
Causes of Under recovery - Entry

- Reserve prices for capacity are driven by baseline
- If baseline capacity were sold out at reserve prices, total revenue would be close to Allowed Revenue
- Entry Capacity
  - QSEC, MSEC and DRSEC have reserve price as minimum
  - DADSEC has 2/3 reserve price as minimum
  - DISEC and WDDSEC have no minimum reserve price
- There has been an increasing trend for shippers to acquire capacity in short-term auctions, particularly where there is :
  - Significant amounts of unsold capacity and
  - Little or no chance of the capacity being interrupted

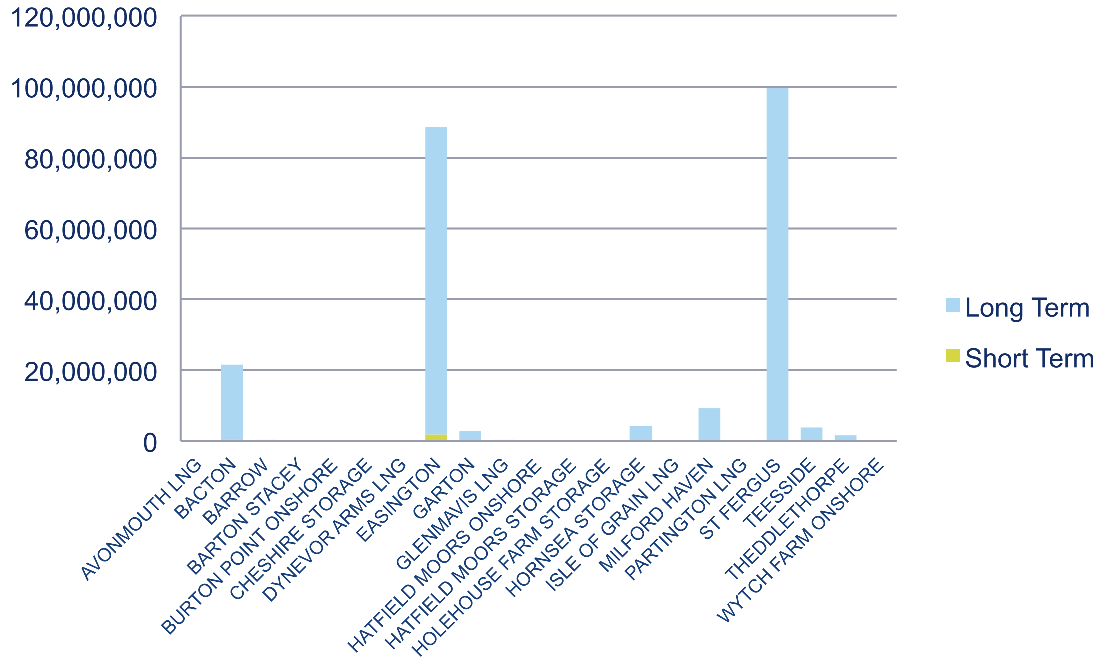
See following slides

- Modification 356 Workgroup has identified the potential for this phenomenon to impact Exit revenues if shippers choose to under-book their current Firm capacity holding

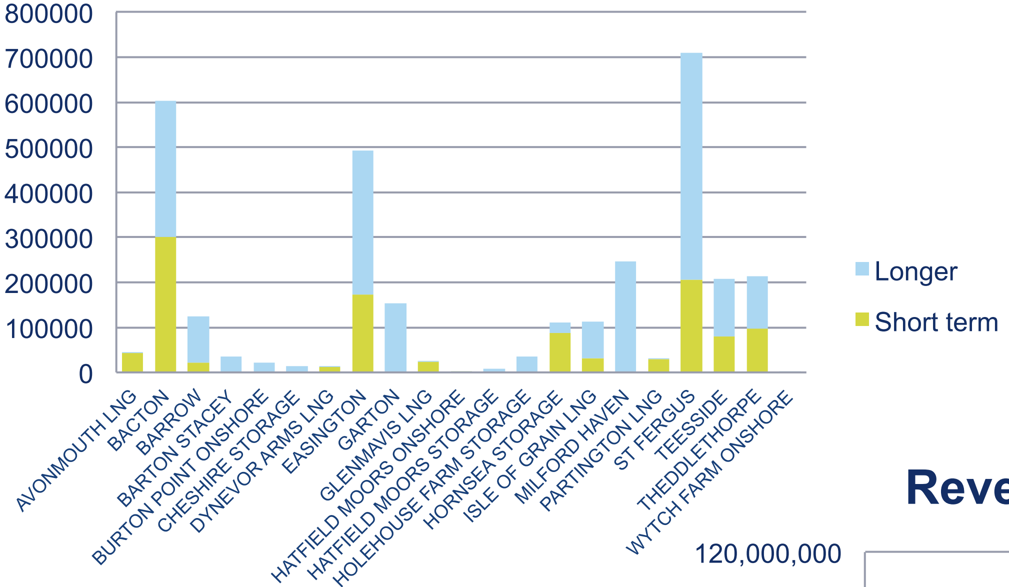
Capacity (GWh/d) sold 2007/08



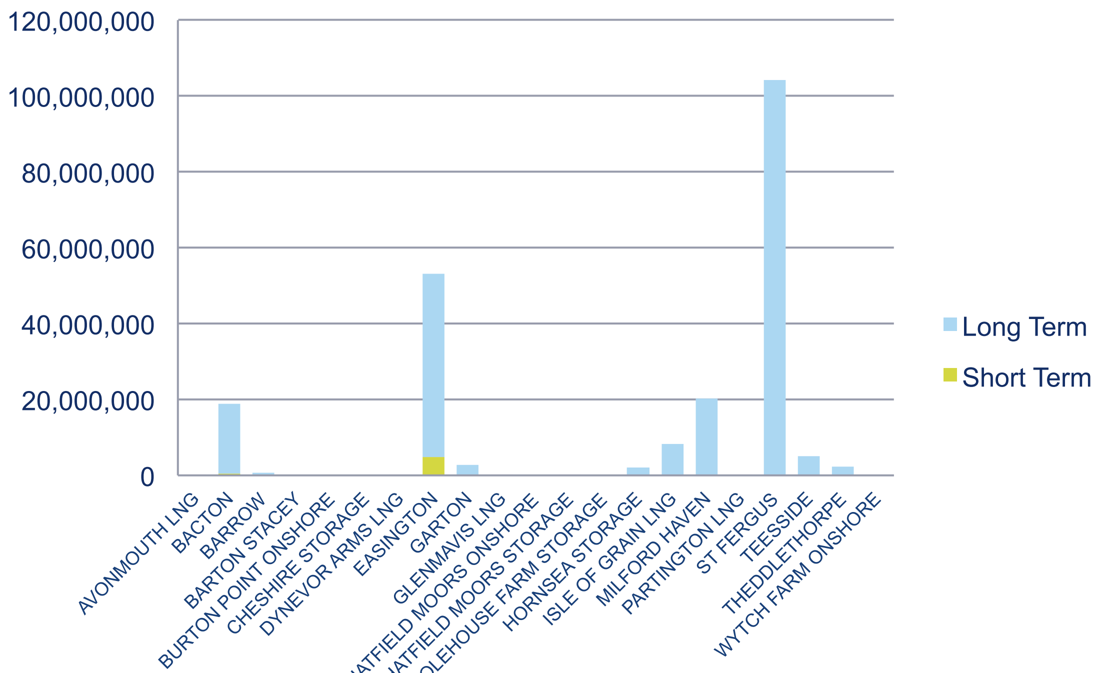
Revenue (£) received 2007/08



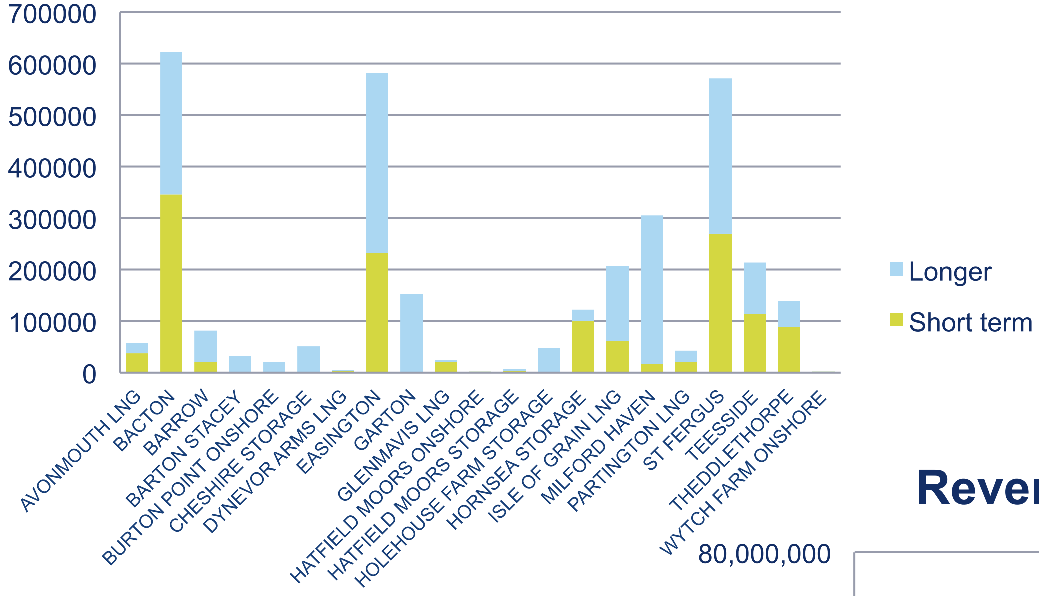
Capacity (GWh/d) sold 2008/09



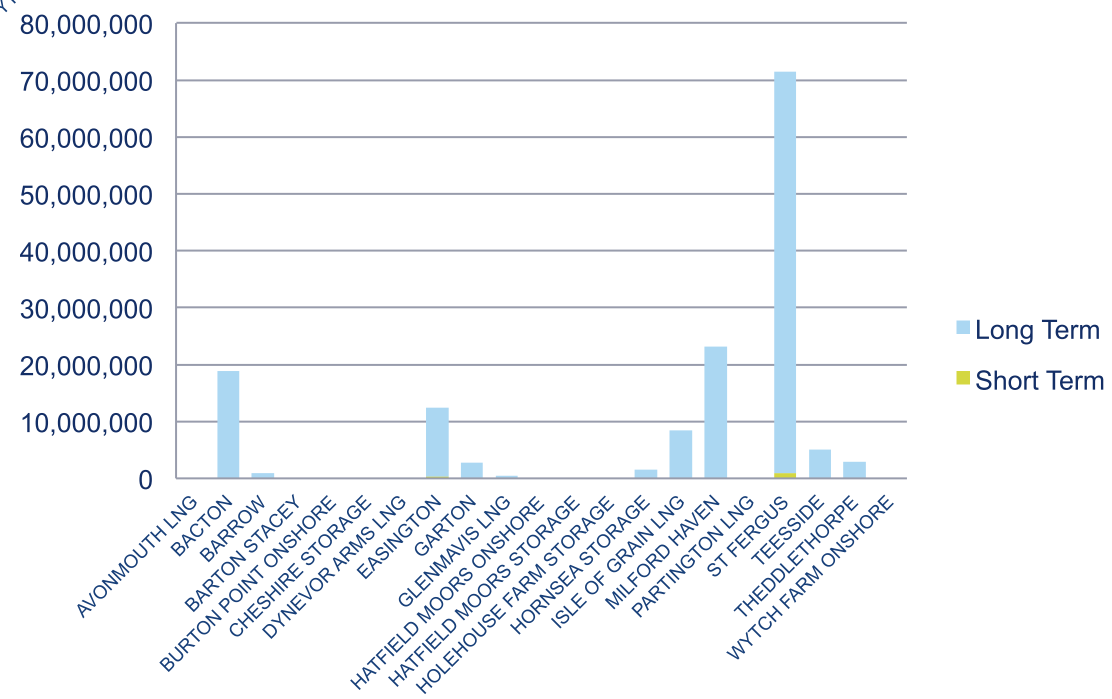
Revenue (£) received 2008/09



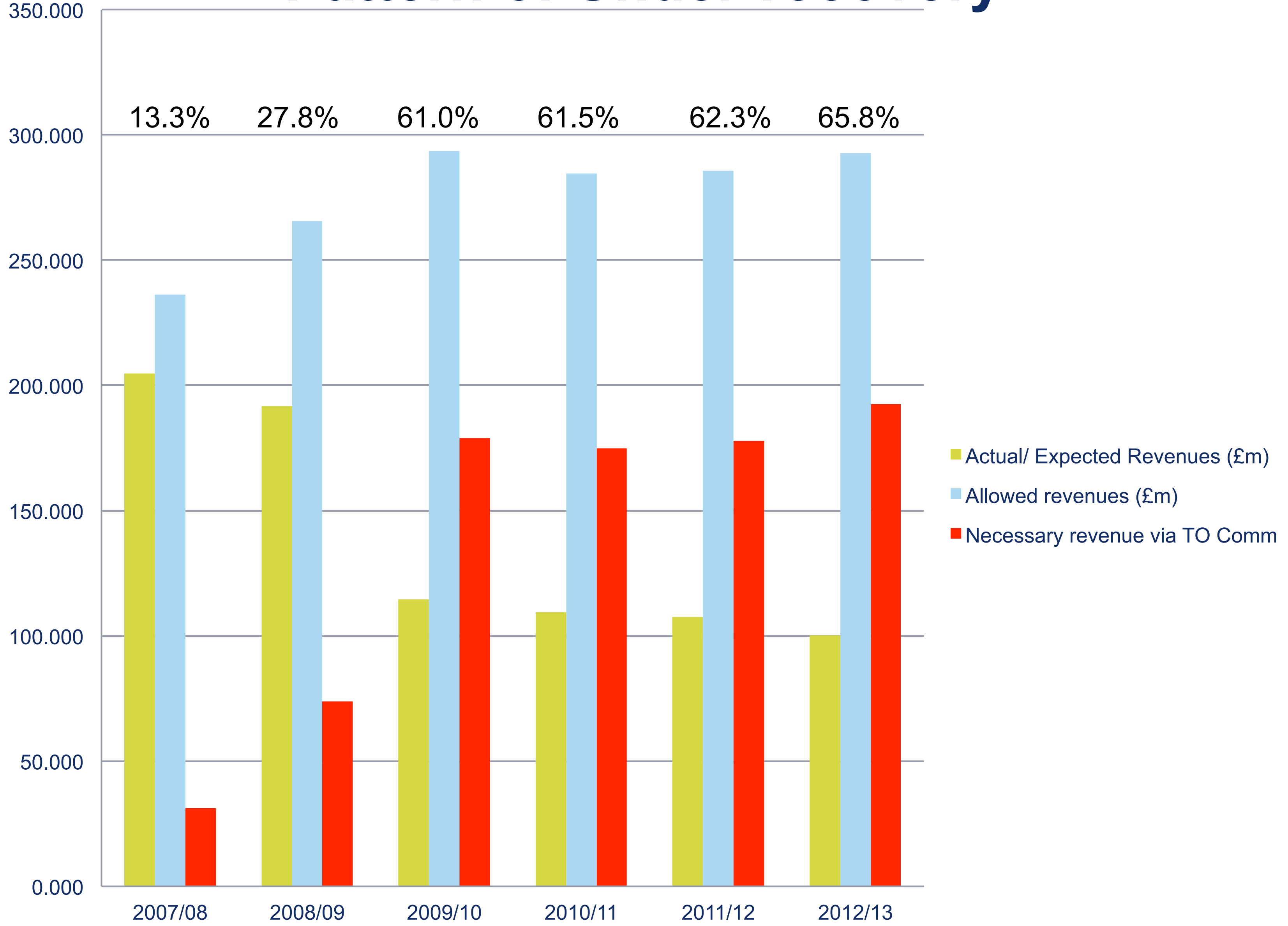
Capacity (GWh/d) sold 2009/10



Revenue (£) received 2009/10



Pattern of Under-recovery



Conclusions

- The aim of recovering 50% of TO Costs from TO Entry capacity charges in a cost-reflective manner is failing badly and giving rise to increasing uncertainty in, and volatility of, future transportation costs
- Greater uncertainty and volatility is likely to feed through to consumers in the form of a risk premium or cost pass-through and could adversely affect competition in supply
- The situation is likely to be exacerbated when a TO Exit Commodity Charge is introduced
- It would be remiss of the industry to allow this situation to persist or worsen
- We therefore recommend that the Workgroup agrees to develop a plan of work to address and remedy the problem