Modification proposal:	**UNC 348: NTS Optional Commodity tariff – update to application rules**		
Decision:	The Authority[1] directs that this proposal be made[2]		
Target audience:	The Joint Office, Parties to the UNC and other interested parties		
Date of publication:	29 June 2011	Implementation Date:	1 February 2012

Background to the modification proposal

National Transmission System (NTS) customers can elect to pay the NTS optional commodity tariff (also known as the short haul tariff) as an alternative to paying standard NTS commodity charges. The NTS optional commodity tariff is designed to reflect the actual costs of laying and operating a dedicated pipeline from an entry point to a nearby exit point, and thereby reduce the incentive on shippers to bypass the NTS to avoid paying standard NTS commodity charges. The tariff is calculated as a function of the exit flow rate and pipeline distance. This proposal seeks to clarify and improve the cost reflectivity of the approach used in calculating the NTS optional commodity charge.

National Grid Gas recovers its System Operator (SO) allowed revenues through SO commodity charges levied on entry and exit gas flows. It aims to recover its Transmission Owner (TO) allowed revenue through capacity charges levied on the sale of both entry and exit capacities. Where the revenue recovered from entry capacity charges falls short of the target, NGG levies a TO commodity charge on shippers based on actual entry flows.

Where an exit point is situated close to an entry point, it may be more economic for that user to build a dedicated line that bypasses the NTS in order to avoid being subject to SO and TO commodity charges. If the NTS was already able to cope with the user's exit capacity requirements, then such a bypass would be uneconomic for the industry as a whole (and end consumers). Any contribution to NGG allowed revenues by not by-passing the NTS lowers the average charge to the remaining users, with consequential benefits to end consumers.

The modification proposal

UNC modification 348 proposes three changes to the rules for calculation of the optional commodity tariff:

- Measuring from the closest System Entry Point (SEP) to the nominated exit point in situations where there is more than one SEP within an Aggregated System Entry Point (ASEP)
- Only allowing a pro-rata flow allocation mechanism when applying the optional commodity charge to multiple exit points from a single entry point
- Disallowing NTS storage sites being nominated as optional commodity tariff exit points

Each of these changes is described in more detail below.

[1] The terms 'the Authority', 'Ofgem' and 'we' are used interchangeably in this document. Ofgem is the Office of the Gas and Electricity Markets Authority.
[2] This document is notice of the reasons for this decision as required by section 38A of the Gas Act 1986.

Distance from the nominated entry point

At present, the optional commodity tariff is calculated using the straight line distance between the exit and entry points nominated by the shipper. In circumstances where the shipper has nominated an entry point which is an ASEP containing multiple SEPs, NGG measure from the midpoint within the ASEP.

The proposer is concerned that using the midpoint does not reflect the reality of the physical connection to the NTS (particularly where there is a significant distance between the SEPs) and could lead to a higher optional commodity tariff being set. In turn, this may make it more likely that the shipper chooses to bypass the NTS.

The proposer wishes to amend the measurement of distance from ASEPs which contain multiple SEPs to the minimum of each of the distances of each SEP contained within the nominated entry point. The proposer considers that measuring the distance from the SEP closest to the specified exit point will better reflect physical connection arrangements onto the NTS and be more cost reflective.

Application to multiple exit points from a single entry point

The current methodology for calculating the optional commodity tariff allows shippers to nominate more than one specified exit point against a single entry point. In circumstances where there is insufficient entry flow to meet the required exit flows, NGG's standard approach is to pro-rate the entry flow in proportion to the exit flows at the multiple exit points. However, the UNC allows shippers to request that NGG consider an alternative allocation.

The proposer wishes to amend the UNC so that shippers can no longer request an alternative allocation mechanism. The proposer states that the optional commodity tariff is calculated assuming a single pipeline, with a high load factor[3], from the nominated entry point to the exit point. Any allocation mechanism other than pro-rata may result in a lower load factor for at least one of the exit points which may reduce the cost reflectivity of the charge. The proposer also considers that accommodating alternative allocations would require a system change, the costs of which are likely to outweigh any potential benefits. To date, no such alternative allocations have been requested by users.

Application of the optional commodity tariff to NTS storage sites

Shippers can nominate NTS storage sites as specified exit points for the optional commodity tariff. This means a shipper can elect to pay the optional commodity charge on gas flows between a specified entry point and an NTS storage site, and so avoid paying entry commodity charges.

The proposer believes that allowing storage sites to be nominated as exit points is the result of an oversight when introducing the optional commodity tariff. At the time of the tariff's introduction, commodity charges were only payable on gas exit flows. However, commodity charges are now also payable on gas entry flows.

[3] A load factor of 75% is assumed in tariff calculations. Any reduction in the load factor results in a greater pipe size being required to meet the flow requirements, with a consequential increase in tariff.

The proposer considers allowing storage sites to be nominated as exit points undermines the principle that gas flowing through storage sites should only pay commodity charges on system entry and exit[4]. Therefore, the proposer considers it would be more cost reflective to remove the eligibility for storage sites to be nominated as exit points for the optional commodity charge.

Although these proposed changes affect the applicability of the charging methodology to certain classes of user and affect some of the inputs used in the determination of the charge, they do not affect the determination of the NTS optional commodity tariff. On this basis, the proposal is assessed against the UNC relevant objectives.

UNC Panel[5] recommendation

The UNC modification panel considered UNC 348 on 21 April 2011 and of the ten possible votes, nine were cast in favour of implementing the modification.

The Authority's decision

The Authority has considered the issues raised by the modification proposal and the FMR dated 27 May 2011. The Authority has considered and taken into account the responses to the Joint Office's consultation on the modification proposal which are attached to the FMR[6]. The Authority is satisfied that:

1. implementation of the modification proposal will better facilitate the achievement of the relevant objectives of the UNC[7]; and

2. directing that the modification be made is consistent with the Authority's principal objective and statutory duties[8].

Reasons for the Authority's decision

We are of the view that UNC 348 will better facilitate the achievement of the UNC relevant objectives below.

SSC A11.1 (c): efficient discharge of the Licensee's obligations

In our view each aspect of the proposal will better facilitate the efficient discharge of the Licensee's licence obligation to administer cost reflective transportation charges[9]. The optional commodity tariff is designed to reflect the costs of laying and operating a dedicated pipeline from an entry point to a nearby exit point. For users close to a SEP,

[4] Standard TO and SO commodity charges are not paid at entry and exit to storage sites, other than for 'own use' gas. This is because the gas flowing into a storage site is considered to have already incurred entry commodity charges when it entered the NTS at an entry point and would incur exit commodity charges as it leaves the NTS at an exit point.
[5] The UNC Panel is established and constituted from time to time pursuant to and in accordance with the UNC Modification Rules
[6] UNC modification proposals, modification reports and representations can be viewed on the Joint Office of Gas Transporters website at www.gasgovernance.com
[7] As set out in Standard Special Condition A11(1) of the Gas Transporters Licence, see: http://epr.ofgem.gov.uk/index.php?pk=folder590301
[8] The Authority's statutory duties are wider than matters which the Panel must take into consideration and are detailed mainly in the Gas Act 1986.
[9] Standard Special Condition A5(5)(a)

this should be a more appropriate charge than standard SO and TO commodity charges. This should reduce the incentive for users to bypass the NTS.

Specifying that the charge for ASEPs with more than one SEP should be based on the shortest distance between the entry and exit point, better reflects the actual costs that would be incurred by users with the option to bypass the NTS. The current ability of users to nominate alternative flow allocations other than pro-rata when an entry flow is being shared amongst exit points has the potential to introduce distortions in the relative cost allocations amongst users, and so could result in users being faced with costs in excess of estimated bypass costs. The removal of this alternative nomination process makes the charges faced by users of the short-haul tariff more cost reflective. As noted by the proposer, it also avoids costs around system changes that could be incurred if this option were to remain.

We also agree that preventing storage sites being nominated as exit points for the calculation of the charge is consistent with the rationale for SO and TO commodity charges not being levied on storage facilities' entry and exit flows. If storage were to be allowed to be nominated as an exit point for the short-haul tariff, the storage charging principles would need to be revisited to ensure that those flows were facing cost-reflective charges.

SSC A11.1 (d): securing effective competition

In our view the proposal will better facilitate effective competition by improving the cost reflectivity of the NTS optional commodity charge. Cost reflective charges reduce the potential of a charging cross subsidy between users, which could otherwise penalise more efficient users and be detrimental to competition. The section above outlines our views on the way in which the proposal will be more cost reflective.

We note that one consultation respondent was concerned that removing the eligibility for storage sites to be nominated as exit points in the calculation of the optional commodity tariff could make it less likely that shippers choose to utilise storage gas. The respondent was concerned that this could undermine GB gas security of supply but no cost estimate was provided of the effect the modification could have.

As noted in the section above, in our view, UNC 348 will increase the cost reflectivity of the charges levied on transporting gas to NTS storage sites. There are a range of factors that determine how much gas shippers choose to store in gas storage sites. From the information presented in the proposal and its responses, we are content that the proposal will not have a significant bearing on this balance.

SSC A11.1 (f): Efficiency in the implementation of the network code

The current UNC text states that shippers may request an allocation mechanism other than pro-rata when the optional commodity tariff is applied from a single entry point to multiple exit points.

We agree with the proposer that the current UNC text lacks clarity with regard to the process such a request might follow and may not reflect the difficulties in implementing an alternative allocation mechanism. In this regard, removing the ability for shippers to request alternative allocation mechanisms creates greater certainty over how the charge will be calculated and administered by NGG. That no shippers who have opted for the optional commodity tariff to be applied to multiple exit points have requested alternative allocation mechanisms may indicate a lack of need for this option.

We also note that there is potential ambiguity with the current approach to measuring from the midpoint when an ASEP contains more than one SEP. While it is established that the midpoint will be used, it is done so at NGG's discretion, rather than as a requirement of the UNC. The proposal will codify where the measurement from the specified entry point will begin, which should increase clarity and certainty for shippers.

Timing of implementation

The FMR outlined several possible implementation dates. The earliest was to implement the modification from 1 August 2011 to apply to transportation charges starting from 1 October 2011. The proposer considered that a decision from the Authority would be required before 1 June 2011 so the appropriate changes and notifications could be made[10]. In the event that a decision from the Authority was reached after 1 June 2011, but before 1 December 2011, the FMR proposed that the proposal be implemented on 1 February 2012 to apply to transportation charges from 1 April 2012.

The Authority's decision to approve implementation of the proposal falls after 1 June 2011 therefore we direct implementation of the proposal from 1 February 2012.

Decision notice

In accordance with Standard Special Condition A11 of the Gas Transporters Licence, the Authority hereby directs that modification proposal UNC348: 'NTS Optional Commodity Tariff – update to application rules' be made.

Hannah Nixon
Partner, Transmission

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

[10] Since the FMR was not finalised until Friday 27 May, it was not possible to make a decision on the proposal prior to the first implementation date of 1 June 2011 expiring.