4th March 2019

**National Grid Gas’s Conclusions Report following the Preliminary Consultation**

Please be advised that there will be some delay in producing the conclusions report for the preliminary consultation. It will, however, be published before the formal consultation is launched.

**Appendix I – Further detail regarding the economic test**

**Summary of current test** (Entry capacity, Non Interconnection Points)

The current test compares the incremental revenue against a project value for delivering the incremental capacity. As long as the incremental revenue >= 50% of the project value then the test is passed. This ensures that the User has demonstrated sufficient commitment to the project before National Grid invests in the network and makes sure there is no undue socialisation of the costs. The LRMC charging methodology is used to calculate the incremental cost of delivering the project (Project Value) and an associated price. This is done for up to 20 different incremental price steps to cover a range of differently sized projects.

**Description of Changes**

A new method for producing project costs that is not dependent upon LRMC is required. There is currently an established methodology for calculating project costs – this is the Generic Revenue Driver Methodology (GRDM) which was introduced at the start of RIIO T1. The GRDM is used to calculate the increase in allowed revenue for National Grid, and so is an accurate reflection of the cost to industry of funding the new investment. The economic test used in the EU network code on Capacity Allocation Mechanisms (CAM code) also requires the use of an ‘estimated increase in allowed revenue’, and so there is precedent in using this approach. It is proposed to adopt the revenue driver calculation as provided by the GRDM.

A new method for producing incremental pricing that is not dependent upon LRMC is required. While incremental price steps (P1 to P20) will continue to be produced for the QSEC auction, they will no longer have any link to the project costs, and therefore will not provide suitable or cost reflective pricing for the incremental project. We also recognise that the current pricing approach limits flexibility for how customers pass the economic test, and may not be conducive to new investment on the network if it forces customers to adopt a capacity profile that is perceived as inefficient or uneconomic. The CAM code test uses the concept of a ‘mandatory minimum premium’, which means that if the economic test cannot be passed at the reserve price, then a premium can be added to allow sufficient revenue to be generated. It is therefore proposed to replace the P1 to P20 price steps with a variable premium that can be set on a project specific basis to allow sufficient revenue to be generated.

Removing the price cap (currently P20) and replacing it with an uncapped premium means that potentially the test could now be passed in a single quarter at very high premium. We believe this would be inappropriate and that a sustained demand for the incremental capacity still needs to be demonstrated. A compromise approach has developed under modification proposal 667 where a commitment is still demonstrated over a minimum of 4 separate years, however it is not necessary to buy up every quarter within those 4 years. We are proposing the same arrangement. But please note that we have also maintained and extended the current 16 quarter minimum booking rule for PARCA applications.

Example scenarios are shown below.

Example: An ASEP has a baseline of 100 and long term bookings as shown below.

A PARCA applicant wishes to book an additional 20 units for a new project.

PARCA booking rule: the PARCA application must have a minimum of 20 units booked across at least 16 quarters out of 32 (from the first quarter booked).

Incremental signal check: the incremental signal will be the highest common amount above baseline (in at least 1 quarter) over 4 separate gas years. This will be subject to a cap of the PARCA amount requested i.e. if the PARCA application is only requesting 20 units then it cannot trigger an incremental amount of > 20.

Consider the following scenarios:

1. The PARCA applicant submits the following booking profile – a flat additional 20 units across the first 16 quarters.

A incremental demand is signalled for 1 quarter (Y1Q1) for 15 units. This is not a sustained demand across 4 different gas years and so the incremental signal is 0.

1. The PARCA applicant submits the following booking profile. 20 units booked in each of the first 16 quarters, plus additional capacity in Y1Q1, Y1Q2, Y2Q1, Y2Q2, Y3Q1 and Y4Q1.

There is a sustained incremental demand across 4 different gas years, and the highest common amount across the 4 years gives an incremental demand of 20 units. There is a signal to release 20 units of incremental capacity to the applicant.

1. The PARCA applicant submits the following booking profile. 20 units booked in each of the first 16 quarters, plus additional capacity in Y1Q1, Y2Q1, Y3Q1 and Y4Q1.

There is sustained demand across 4 different gas years, and the highest common amount across the 4 years gives an incremental demand of 30 units. However the PARCA project is only for 20 units across the 16 quarters. A cap of 20 units will be applied on the incremental capacity considered for release. (To signal 30 units of incremental capacity the applicant would need to book a minimum of 30 units across the 16 quarters).