Kelvin Bradbury
Regulatory Finance Partnering Manager
National Grid Gas plc

Email: Gas.TransmissionResponse@ofgem.gov.uk
Date: 25 October 2021

Dear Kelvin,

Direction for the value of the Penal Rate Proportion (PRP_t) for the National Grid Gas plc Gas Transporter Licence in respect of Regulatory Year 20/21 publication.

On 5 July 2021, National Grid Gas plc (NGG) submitted a request to the Authority[1] under Part H of Special Condition 2.1 of the National Gride Gas plc Gas Transporter Licence (the Licence) that the Authority direct a value of zero from the PRP_t in respect of the Regulatory Year starting 1 April 2020. On 23 September 2021 and 29 September 2021, NGG sent additional information relating to their request.

Following an assessment of the request and the supporting information provided, we have decided to direct a PRP_t value of zero for the Regulatory Year starting 1 April 2020.

Background

The PRP_t is the "penal rate proportion" and its value determines what proportion of the 1.15% penal rate should be applied to the difference between NGG's Allowed Revenue and Recovered Revenue for a Regulatory Year. A PRP_t value of one means that the 1.15% penalty is applied to the full under- or over-recovery of revenue, and a PRPt value of zero means that no penalty is apply to any under- or over-recovery of Allowed Revenue.

Paragraph 15 of Special Condition 2.1 of the Licence says that the Authority may direct a value for the PRP_t which is not less than zero and not more than one if we are "satisfied

[1] References to the "Authority", "Ofgem", "we" and "our" are used interchangeably in this document. The Authority refers to GEMA, the Gas and Electricity Markets Authority. The Office of Gas and Electricity Markets (Ofgem) supports GEMA in its day to day work. This decision is made by or on behalf of GEMA.

that the difference between TO Recovered Revenue and the Allowed Revenue is for reasons outside the reasonable control of the licensee [NGG]".

For the Regulatory Year starting 1 April 2020, NGG's TO Recovered Revenue was £120m lower than their Allowed Revenue of £780m. On 5 July 2021, NGG requested that we direct a value of zero for the PRP_t in respect of the Regulatory Year starting March 2020 because in their view "the difference between TO Recovered Revenue and Allowed Revenue in Regulatory Year 20/21 is for reasons outside the reasonable control of NGG."

NGG say there are two reasons which caused the under-recovery:

- the impact of some Capacity Neutrality payments not contributing towards TO Recovered Revenue, resulting in **£47m under-recovery**; and
- the implementation of UNC678A from October 2020 significantly affecting the efficacy of NGG's charging methodology in setting prices that would have accurately recovered Allowed Revenue, resulting in **£73m under-recovery**.

On 23 September 2021 and 29 September 2021, NGG sent additional information, including analysis of the specific impact of Existing Contracts[2] on NGG's charging methodology. NGG say that the net under-recovery resulting from UNC678A impacts on NGG's charging methodology can be broken down into:

- **£45m under-recovery** resulting from the impact of Existing Contracts; and
- **£28m under-recovery** resulting from the impact of forecasted capacity being higher than the actual contracted capacity.

NGG also said that they were limited in their ability to control the amount of TO Recovered Revenue after the Gas Year beginning 1 October 2020 had commenced through a Revenue Recovery Charge (**RRC**) as "NGG decided that the interests of consumers and the stability of the GB gas market would not be best served by setting an RRC which sought to fully recover NGG's Allowed Revenue during FY21 as the RRC required to achieve this would have been significantly higher than the market could bear at that time."

Our view

We consider that **£91.5m** of the difference between NGG's Allowed Revenue and Recovered Revenue for Regulatory Year 20/21 was for reasons outside of the reasonable control of NGG. This means that the under-recovery which was within the reasonable

[2] "Existing contracts" are certain fixed-price capacity bookings and contracts registered prior to 6 April 2017 in accordance with Article 35 of Commission Regulation (EU) 2017/460 of 16 March 2017 establishing a network code on harmonised transmission tariff structures for gas (TAR NC). TAR NC is now incorporated in UK law by the European Union (Withdrawal) Act 2018 and the European Union (Withdrawal Agreement) Act 2020, as amended by Schedule 5 of the Gas (Security of Supply and Network Codes) (Amendment) (EU Exit) Regulations SI 2019/531.

control of NGG was approximately 3.6% of Allowed Revenue. The licence determines that a penalty is zero where the difference between TO Recovered Revenue and Allowed Revenue is below a 6% threshold. Since the under-recovery within the reasonable control of NGG was below 6% of Allowed Revenue, we consider that the penal rate adjustment would have been zero if it were not for factors beyond NGG's reasonable control. Therefore, we direct that the PRP_t should be zero for the Regulatory Year starting 1 April 2020.

Capacity Neutrality arrangements

We agree with NGG that the £47m of under-recovery was attributable to the impact of Capacity Neutrality payments not contributing towards TO Recovered Revenue and that this was beyond the reasonable control of NGG.

During the period from 1 October 2020 to 1 January 2021, Capacity Neutrality arrangements meant that significant revenues were redistributed across entry users and did not contribute to TO Recovered Revenue. In our UNC748 decision,[3] we said that we consider that treatment of interruptible and within day firm entry capacity within the capacity neutrality arrangements during this period was inappropriate[4]. This impact was not foreseen prior to the commencement of the Gas Year on 1 October 2020. When the impact of the capacity neutrality arrangements on TO Recovered Revenue was identified, NGG followed the 'urgent' modification process to mitigate the impact through UNC748, which was approved by Ofgem on 23 December 2020 and implemented on 1 January 2021[5][6].

Therefore, we consider the impacts of the capacity neutrality arrangements between 1 October 2020 and 1 January 2021 on under-recovery to be beyond NGG's reasonable control. We agree that the impact on under-recovery was £47m, which was the amount of revenue distributed through the capacity neutrality mechanism which would otherwise have contributed to TO Allowed Revenue.

Existing Contracts and forecasting errors

We agree with NGG that £45m is a reasonable estimate for the amount of under-recovery attributable to the impact of Existing Contracts on NGG's charging methodology and that this under-recovery was beyond the reasonable control of NGG. We disagree that the remaining £28m attributable to NGG's charging methodology was beyond the reasonable control of NGG.

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[3] UNC748 Prospective Removal of Entry Capacity Revenue from Capacity Neutrality Arrangements: Decision (23 December 2020) https://www.ofgem.gov.uk/publications/unc748-prospective-removal-entry-capacity-revenue-capacity-neutrality-arrangements-decision

[4] https://www.ofgem.gov.uk/publications/unc748-prospective-removal-entry-capacity-revenue-capacity-neutrality-arrangements-decision

[5] https://www.gasgovernance.co.uk/0748

[6] https://www.ofgem.gov.uk/publications/uniform-network-code-748-urgent-prospective-removal-entry-capacity-revenue-capacity-neutrality-arrangements-urgency-application

The price protection for Existing Contracts was implemented on 1 October 2020 as part of UNC678A and it was a requirement of Article 35 TAR NC. Analysis presented by NGG demonstrates that the significant utilisation of Existing Contracts in the Gas Year starting 1 October 2020 had the effect of increasing the impact of forecasting errors on the actual levels of under-recovery for Entry capacity. NGG analysis demonstrates that the mean absolute forecasting error for NTS Entry capacity between October 2020 and March 2021 was 5%, but that significant utilisation of Existing Contracts, and the difficulty in forecasting Existing Contract utilisation, contributed to a far greater variance between forecast and actual TO Revenues. Using actual demand and capacity reserve prices for the period, NGG estimate that TO Recovered Revenue would have been £45m closer to Allowed Revenue in the absence of Existing Contracts. Based on this analysis, we agree that the impact of Existing Contracts on NGG's charging methodology was beyond NGG's reasonable control and that NGG's estimate of £45m is a reasonable estimate for the amount of under-recovery attributable to this.

NGG have said that the remaining £28m under-recovery is attributable to NGG's forecasting being higher than actuals and that this was beyond NGG's reasonable control as shipper behaviour from October 2020 deviated significantly from what NGG anticipated. We disagree that this was beyond NGG's reasonable control. It is NGG's role to maintain a methodology which takes account of forecast demand and reflect how Users will change their approach to procuring NTS Capacity. We expect this role to be within the reasonable control of NGG except where NGG clearly demonstrates specific extraordinary circumstances that have prevented this.

Authority direction

Following an assessment of the request and the supporting information provided in accordance with paragraph 15 of Special Condition 2.1, we have decided to direct a PRP_t value of zero for the Regulatory Year starting 1 April 2020.

If you have any questions on the above, please contact:
Gas.TransmissionResponse@ofgem.gov.uk.

Yours Sincerely,

Eleanor Warburton

Deputy Director, Energy System Management and Security

Signed on behalf of the Authority and authorised for that purpose