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Kelvin Bradbury
Head of Regulatory Finance
National Gas Transmission plc

Email: gas.systems@ofgem.gov.uk
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Dear Kelvin,

Direction for the value of the Penal Rate Proportion ($SOPRP_t$) for the National Gas Transmission plc Gas Transporter Licence in respect of Regulatory Year 2023/24

On 30 September 2024, National Gas Transmission plc (NGT) submitted a request to the Authority[1] under Part G of Special Condition 2.3 of their Gas Transporter Licence (the Licence) that the Authority direct a value of zero for the SOPRPt in respect of the Regulatory Year starting 1 April 2023. On 29 October 2024 and 5 November 2024, NGT submitted additional information in response to Ofgem's queries.

Following an assessment of the request and the supporting information provided, we have decided to direct a SOPRPt value of zero for the Regulatory Year 2023/24.

Background

The SOPRPt is the "penal rate proportion" and its value determines what proportion of the 1.15% penal rate adjustment (SOPRAt) should be applied to the difference between NGT's Allowed Revenue and Recovered Revenue for a Regulatory Year. A SOPRPt value of one means that the 1.15% penal rate adjustment is applied in full to any under- or over-recovery of revenue, and a SOPRPt value of zero means that no adjustment is applied to any under- or over-recovery of Allowed Revenue.

Paragraph 2.3.14 of Special Condition 2.3 of the Licence says that the Authority will direct a value for SOPRPt which is not less than zero and not more than one if we are "satisfied that differences between SO Recovered Revenue and SO Allowed Revenue were for reasons outside the reasonable control of the licensee [NGT]."

[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.

NGT’s request

For the Regulatory Year 2023/24, NGT’s SO Recovered Revenue was **£199.21m** lower than their SO Allowed Revenue of **£933.8m**. On 30 September 2024, NGT requested that we direct a value of zero for the SOPRPt in respect of the Regulatory Year starting 1 April 2023 because in their view “the under-collection of revenue in Regulatory Year 2023/24 was driven predominantly by elements outside of [NGT’s] control.”

NGT said the drivers for the under-recovery can be split broadly into three categories; throughput (flow) variances, other charging variations, and SO Allowed Revenue adjustments (from FY23/24 to FY24/25). NGT also cited an ‘analysis variance’ that contributes to the under-recovery amount. These items and the reasons/evidence that NGT have submitted to us are summarised below:

Throughput (flow) variance (c.£63m)

- NGT stated that there was a significant drop off in domestic demand across both Local Distribution Zones (LDZ) (£42.4m) and Exports to Ireland (£12.4m) which accounted for c.85% (c.£54.8m) of the total throughput variance. NGT said, in line with other industry forecasts, the level of domestic demand was over-stated which was based on historic profiles and the full impact of the cost of living crisis and increase in domestic bills resulted in unprecedented drop in consumption across the Gas Year.
- There was a NTS Industrial under-recovery of c.£5.1m, which was offset by a NTS Power Generation over-recovery of c.£6.3m. The combined revenue impact of these two large directly connected customers equals a c.£1.1m over-recovery.
- The variances in Exports to Europe (c.£10m) and NTS Shrinkage (£20,567) also contributed to the total throughput variance.

Other charging variations (c.£23m)

- A St Fergus compression revenue variance of c.£10.7m, at the North Sea Midstream Partners (NSMP) sub terminal. Based on past trends, NGT forecasts suggested a correlation between flows and the St Fergus Compression Charges. When the Compression Charges fell in October 2023, NGT expected that flows would increase, however this was not realised.
- A Non-Obligated Exit Capacity revenue variance of c£6m: linked to lower demand, the actual recovered revenue was a lower value than forecast by almost half. NGT stated that Non-Obligated Capacity by its discretionary nature is difficult to forecast, and can be event driven.

- A variance in the forecasts for Storage net injection/withdrawal positions of c.£6.3m. The amount of gas injected and withdrawn from Storage impacts the level of gas flows on the network. To reflect this, there is a forecast adjustment to Entry flows that are subject to Entry General Non-Transmission Service Charges (GNTS).

Revenue adjustment (c.£107m)

NGT stated that this revenue variance was due to their decision in July 2023 to purposefully under-collect £100m against the Price Controls Financial Model (PCFM) Allowed Revenues when setting General Non-Transmission Services charges in Gas Year 2023/24 to improve tariff stability. NGT said that an additional £7m is the result of updates accommodated to SO Allowed Revenue as part of the Price Control Financial Model (PCFM) process [2]. As per this process, the Allowed Revenue set out in the PCFM was increased by about £7m once updated with actual values not available at the time of the May 2023 PCFM re-publication. Therefore, there is an under-recovery to this level that was not possible to include into charge setting.

Analysis variance (£5m)

NGT included in their breakdown of the under-recovery amount an 'analysis variance' of c.£5m. NGT explained this variance is the result of comparing the sum of the constituent components to the total under-recovery position for Regulatory Year 2023/24, and the natural and unavoidable result of the process used for the presentation of the under-recovery values.

In response to our queries, NGT provided supplementary information and data to support their claim. NGT explained that in forecasting the demand of their network, they accommodate a reflection of market behaviours and their approach is continually being monitored in order to incorporate insight and up to date data. This includes the latest demand forecasts and how network users potentially change their approach by sector and overall. NGT stated that if every effort has been made to use the best available value for setting charges so that it reflects a view that can be justified to NGT customers, then deviation between forecast and actual values may be considered outside the control of the methods applied in the production of forecasts.

[2] Price Control Financial Model – sets out the amount of revenue NGT can recover in a Regulatory Year. Published by Ofgem and updated throughout the year.

Our view

In line with our previous decisions on similar requests from NGT to waive a penal interest adjustment in 2021 and 2023[3], we assess each constituent component of the overall revenue variance and consider whether said variance was within or outside of NGT's reasonable control based on the evidence and reasons provided by NGT for that individual component. If we are not able to conclude whether certain variance was outside of NGT's reasonable control, we attribute this part of the variance to within the reasonable control of NGT. The amount of variance we conclude that was and was not within the reasonable control of NGT informs our decision on the value for SOPRPt.

Based on the information provided to us by NGT, we are satisfied that the amount of **£149.72m** of the differences between NGT's SO Recovered Revenue and SO Allowed Revenue for Regulatory Year 2023/24 was for reasons **outside the reasonable control of NGT.** For the remaining **£49.5m,** we are unable to reach this conclusion. We have therefore attributed this part of the under-recovery to reasons within the reasonable control of NGT.

NGT's SO Allowed Revenue for Regulatory Year 2023/24 is **£933.8m** and the under-recovery value which was within the reasonable control of NGT was **5.30%** of SO Allowed Revenue. The licence determines that a penalty is zero where the difference between SO Recovered Revenue and Allowed Revenue is below a 6% threshold. Since £149.72m of the under-recovery was for reasons outside NGT's reasonable control and the amount within the reasonable control of NGT, £49.5m, was below 6% of SO Allowed Revenue, we direct that the SOPRPt should be zero for the Regulatory Year 2023/24.

We set out in the following section our assessment on individual constituent components of the under-recovery in Regulatory Year 2023/24.

Throughput (flow) variance

We agree that the £42.4m under-recovery attributed to drop in LDZ demand was likely outside of the reasonable control of NGT. We note in regards Ofgem's own research and data regularly published by the Office for National Statistics[4], that the cost-of-living and

[3] See, Direction for the value of the PRPt (penal rate proportion) of the National Grid Gas plc Gas Transporter Licence in respect of Regulatory Year starting 1 April 2020 | Ofgem, and Letter on the penal interest rate and Gas Year 2023/24 | Ofgem

[4] ONS regularly publishes survey data on people's experiences of changes in their cost of living and household finances including if they would use less fuel such as gas or electricity at home because of the increases in the cost of living. For details, please refer to their website: Public opinions and social trends, Great Britain: household finances - Office for National Statistics.

energy price crisis may have had an impact on domestic energy consumption, although it is difficult to quantify the precise impact in Regulatory Year 2023/24. In response to our queries, NGT provided additional data including the Future Energy Scenarios (FES) forecast demand for the last five years. NGT explained that they would reflect on what patterns they had seen in the LDZ demand and consider if any adjustment might be warranted. The FES LDZ forecast was notably reduced for 2023/24 compared to previous year's forecasts, responding to the historic drop in actual flows in 2022/23. NGT believed the 2023/24 forecast did reflect FES's latest view of domestic demand forecasts that NGT used in their assumptions. As the recipient of the FES forecasts, NGT said they did not make further adjustments to this FES forecast given the step change from previous forecasts. While one may question NGT's decision not to further adjust the FES forecast in view of the actual flows in 2022/23, we note that the FES forecast for 2023/24 was reduced by 7.7% compared to the previous year's forecast in response to the historic drop in actual flows in 2022/23, which were exceptionally low compared to the previous three years. On balance we think it was not unreasonable for NGT to take the view that the FES forecast had suitably reflected the downward trend of domestic demand. We therefore accept that the actual flows in 2023/24 were lower than those in 2022/23, and this was not something that NGT could reasonably foresee. However, we disagree that this reasoning also accounts for the forecasting variance seen in Exports to Ireland (£12.4m). The historic trends in actual flows in Exports to Ireland are different; there was not a significant drop in 2023/24 as seen in LDZ demand and we consider changes in domestic demand alone do not sufficiently explain the variance in this constituent component. For this reason, we could not conclude that the forecasting variance attributable to Exports to Ireland was outside of the reasonable control of NGT.

Regarding NTS industrial, NTS Power Generation, Exports to Europe and NTS Shrinkage, NGT provided numerical data to highlight the revenue variances but did not provide specific reasons to explain how the amounts of under-recovery were driven by specific issues and justifications on why these issues were outside of NGT's reasonable control. In the absence of any information to the contrary, we therefore do not conclude that these variances were outside of the reasonable control of NGT.

Other charging variations

We disagree that the St Fergus compression variance of c.£10.7m was outside of the reasonable control of NGT. While we do not disagree that there could be some correlation between flows at the NSMP sub terminal and compression charges, we note that when charges went up from 0.0169 in Gas Year (GY) 2021/22 to 0.0514 in GY2022/23, there was a 20% drop in actual flows from October 22 to March 23 when compared to the period spanning October 21 - March 22. Charges then fell to 0.0152 in GY2023/24 and returned to a similar level as in GY2021/22 but NGT's forecast flows for October 23 - March 24 were 113% and 70% higher than the actual flows in October 22 - March 23 and October 21 - March 22 respectively. The predicted increase in NGT's forecast was in our view abnormally and disproportionately high, which contributed to significant revenue variance. We consider that the reason provided by NGT on the correlation between charge and flows does not sufficiently justify their high forecast so we do not conclude that the forecast variance in revenue in this constituent component was due to reasons outside of NGT's control.

We disagree that the revenue variances of Non-Obligated Exit Capacity and Storage injection/withdrawal net positions were for reasons outside of the reasonable control of NGT. NGT provided numerical data to highlight the revenue variances but did not provide specific reasons to explain how the amounts of under-recovery were driven by specific issues or justifications on why these issues were outside of NGT's reasonable control. In the absence of any information to the contrary, we do not conclude that these variances were outside of the reasonable control of NGT.

Revenue adjustment
We confirmed in our decision letter in July 2023[5] that penal interest would not be applied on any under-recovery attributable to this decision to purposefully under-collect £100m against the PCFM allowed revenues by NGT. Hence, for the purpose of this assessment and decision we will treat this under-recovery of £100m as outside of NGT's reasonable control. We also agree that the additional £7m attributable to the updates to the SO Allowed Revenue via the PCFM process were outside of the reasonable control of NGT.

Analysis variance
We disagree that the c£5m attributable to an 'analysis variance' is outside of the reasonable control of NGT. We consider that the process used to present the under-recovery information is within NGT's control.

Potential licence updates

NGT is required by the Uniform Network Code (UNC) to set its transportation charges that apply on a Gas Year basis (1 October – 30 September), which are calculated by taking into account the allowed revenues of two Regulatory Years (1 April – 31 March) that span the Gas Year. This methodology was delivered by two UNC modifications, namely UNC796 and UNC857, which were approved by Ofgem in May 2022 and April 2024 respectively with the intention to smooth tariffs. This UNC charging methodology could lead to 'deliberate' over- or under-recovery in a Regulatory Year.

[5] See, Letter on the penal interest rate and Gas Year 2023/24 | Ofgem

NGT stated that the measurement on the application of penal rate adjustment in the licence does not fully reflect the introduction of UNC796 and UNC857 because the revenue target in a Gas Year is effectively determined by a UNC charging methodology not using the explicit values determined on a Regulatory Year basis per the licence. NGT suggested it is necessary to review aspects of the licence dealing with the measurement and performance of revenue recovery and the application of the penal interest adjustment. NGT welcome reviewing the principle, timing and relevance of penal rate adjustment in future years and working with Ofgem on any future licence changes.

We note NGT's request that following the implementation of UNC796 and UNC857 there is a need to review aspects of the licence dealing with the measurement and performance of revenue recovery and the application of the penal interest adjustment. We consider this request reasonable although we note that the current licence conditions do not cause a material impact on NGT because we view any deliberate over/under recovery as a result of the UNC charging methodology as outside of NGT's control when making a decision on the penal rate proportion.[6] We are open to examining whether and how the relevant licence conditions could be updated to better reflect the latest UNC charging methodology. We would also like to take this opportunity to review whether the current licence conditions relating to how Ofgem may partly apply or waive the penal element for under and over-recoveries outside the reasonable control of NGT should be updated to add clarity on how Ofgem will determine the penal rate proportion. It is our intention to work with you in the next few months on this matter.

Authority direction

In accordance with paragraph 2.3.14 of Special Condition 2.3, we have decided to direct a SOPRPt value of zero for the Regulatory Year 2023/2024. If you have any questions on this decision, please contact Donald Lam or Paul Bass at gas.systems@ofgem.gov.uk.

Yours sincerely,

Dr Adrian Richardson

Deputy Director, Energy Markets & Security

Signed on behalf of the Authority and authorised for that purpose

[6] For example, see our previous decision on a penal interest waiver request by NGT in 2023: Direction for the PRPt value in Regulatory Year 2022/23 | Ofgem