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Dear David,

Gas Transmission Charging Review – Call For Evidence

Thank you for this opportunity to provide input to the early stages of Ofgem's gas transmission charging review. Given the open nature of this initial consultation, this response necessarily sets out only our high level views on the scope, priorities and timing that we believe should apply. Our views on these and other charging related issues will crystallise during the review process.

Background

We welcome this review as both necessary and timely. Certain elements of the GB gas charging arrangements are now well past their sell by date. In particular, we have been a strong critic of the TO Entry Commodity charge for many years. As long ago as 2011 we provided evidence to Ofgem on the distorting effects of applying high levels of commodity charges to cross border flows. This evidence reinforced the other, well documented issues with this charge including a flight to short term discounted capacity, cross subsidies between shippers which undermine competition, and unwelcome volatility in charges. We are pleased that these issues now appear to have been recognised.

The Framework Guidelines and subsequent Network Codes which are emerging from the EU regulatory arena will require changes to the way we buy, manage and pay for pipeline capacity and associated network services in GB. This review therefore provides an ideal opportunity to ensure alignment with these new requirements as well as providing an extra degree of "future proofing", stability and transparency to charging arrangements.

Scope of the review

Ofgem has clearly stated that National Grid's overall allowed revenue – as set out in its gas transporter licence following the RIIO-T1 price control – will not form part of this review. Whilst there may be elements of that price control that we don't agree with, we nevertheless concur with Ofgem's view that the price control settlement should not be reopened at such an early stage. Our comments below therefore assume that National Grid's overall allowed revenue is fixed.

The total allowed revenue is collected through a number of complex and highly interrelated charges. As well as being structured to recover the total allowed revenue, these also provide incentives on shippers such as locational signals, capacity purchase timings, and notifications to National Grid.

The interdependent nature of many of these charging elements means that it will not be possible to revise one element without at least assessing how such a change may impact on the level of other charges, and the resulting incentives. We would therefore encourage the scope of the review to be as open as possible, otherwise there is a real risk that unintended consequences could materialise, requiring subsequent "sticking plaster" solutions.

We set out below a non-exhaustive list of the key aspects we would expect to be considered. However, we would also caution that this charging review will serve to create additional and unwelcome uncertainty to certain parts of the energy industry. Such uncertainty will exist at least until the outcome of the review is known, and possibly after that if, for example, revised methodologies lead to greater volatility or unpredictability in charging structures. In particular we would note the potential for the uncertainty created by this review to act as a further drag on new CCGT investment decisions.

Transmission system connection charging and arrangements

The government has clearly signalled its support for the exploration and exploitation of Britain's shale gas reserves. Whilst recoverable volumes remain uncertain, shale gas has the potential to reduce prices for customers. It may also enhance national gas security of supply where it is believed that gas imports are less resilient than indigenous production.

Governmental support has recently been extended to include the taxation regime, where lower levels of tax will apply to elements of onshore shale gas production than for more traditional gas reserves. Ofgem and the balance of the industry need to seize this initiative and respond positively.

We can do this by ensuring that produced gas has a competitive route to market with no undue barriers. To this end, Centrica believes that gas transmission connection and charging arrangements must form part of this review. This may conclude that these arrangements are indeed fit for purpose, and no further action is required. However, if arrangements are found to be sub-optimal, we currently have a window of opportunity in which to make the necessary revisions before the first volumes of gas are expected. Not undertaking this review risks otherwise viable shale gas projects being delayed or even cancelled thereby denying consumers the potential benefits.

Consideration of the issues with applying EU-driven arrangements to all domestic and interconnection points

A number of new regulations emerging from the EU arena are mandatory for IPs only. NRAs therefore have some discretion about extending the application of these rules to all domestic points. This principle not only centres on the Tariff Framework Guideline, but also arrangements for allocating capacity and managing congestion.

Therefore, a central point for review must be the extent to which mandatory IP principles are extended national wide.

50/50 entry exit split of allowed TO Revenue

The topic of what proportion of charges should be covered from entry and how much from exit is very much a live one in Europe. Whilst there would appear to be no easy answer to this, we believe that a significant output from this review should be to analyse the optimum split.

Balance between capacity and commodity charges

Across the transmission network, TO allowed revenue makes up approximately two thirds of total allowed revenue, with the remaining third being collected through SO throughput charges. However, conflicting policies including heavy discounting on short-term capacity prices means that outturn figures are closer to just 40% being collected through capacity charges, and 60% through commodity charges. This is notably different from practices in many or even most other gas network jurisdiction, and does not accord with sound economic principles. We also note that from 2008, GDNs have structures their charges to collect 95% of allowed revenue through capacity charges.

Therefore, this review must seek to justify these differences, and more probably rationalise transmission charging structures to correct this anomaly. A key element of this will be a review of the constituent parts of the SO Commodity charge and an assessment to ensure they're correctly allocated.

Hand back of primary capacity to the transporter

Discussions in Europe have signalled potentially a major shift in the way capacity is priced. This adds risk not only around the level of the revised prices, but also the risk of volatility (e.g. in the event of a move towards floating reserve prices). For shippers with locked in long term capacity, this would amount to a retrospective change, something that Ofgem has been adamant it wants to avoid. In the event that this review concludes that material changes to capacity terms and conditions are necessary – whether this is just at IPs or more widely – this review must also consider allowing scope for shippers to hand back their capacity commitments to transporters.

Novation of capacity holdings

Currently, any shipper committing to primary capacity from National Grid remains liable for the capacity charge irrespective of any subsequent sale of the capacity by that shipper. National Grid and shippers have previously debated the prospect of capacity novation to a secondary shipper, thereby allowing the original buyer to be relieved of the financial commitment to NG. This proposal stalled at the time, but we still believe there could be merit in such a concept, particularly where there are concerns over access to capacity.

Transmission Charging Review to be a Significant Code Review

This review should be conducted under the guise of a Significant Code Review (SCR). This will provide rigour and process certainty to stakeholders. Further, it would seem odd to conduct a review of arrangements which are largely set out in the Uniform Network Code (UNC), but do so out with the review mechanism which Ofgem itself established for reviewing such arrangements.

Timings for this Review Process

We understand that the emerging European Network Code on Tariffs is scheduled to come into effect in 2017. Elements of this review which are necessary in order to ensure compliance with that Network Code must therefore be completed in plenty of time to allow any resulting system and process changes – whether these are industry central systems or shippers own IT – to be completed and tested. Time must also be allowed for shippers to analyse the financial impacts of any changes and ultimately adjust their charges to end consumers if this is necessary. We therefore suggest a latest target completion date for this review of Q1 2015.

Responses to Ofgem's Specific Questions

Question 1: What has given rise to the current balance between charges for access to the transmission network? How might this change in future?

We assume views are sought on the balance between capacity and commodity charges (as against, say, the 50/50 allocation to entry and exit). There are two main factors which are driving up the commodity element of network charges, particularly at entry: the general under-recovery caused by an excess of entry capacity, and the sale of increasing volumes of discounted short-term entry capacity. Allied to this, we understand that NG would still not recover its total allowed TO entry revenue, even if all baseline sold out at reserve price. This suggests an unhelpful interaction with the charging model.

The situation at exit seems better, in that while we have seen the introduction of a TO exit commodity charge, this genuinely does seem to reflect the "top up" necessary due to uncertainties over volumes and prices. However, potential exists for this to slip more towards the entry experience as users seek to optimise their capacity holdings.

Question 2: What issues are there with current charging arrangements? For example:

- *Is capacity available when needed?*

  Broadly yes for existing capacity in an environment of low and stable demand. The GB network is characterised by an abundance of capacity at most if not all entry points. Indeed we calculate that there is about twice as much baseline entry capacity as would be needed on a 1:20 peak winter's day.

  However, we are concerned about National Grid's view that new planning arrangements are driving lead times of 7 years for new capacity. This may inhibit the ability of investors to respond rapidly to emerging market requirements, meaning new capacity may not be available when required.

  We consider that integrating the incremental signal into the QSEC process has generally worked well, and believe that this approach should be retained.

- *Do charging arrangements help NGG to plan network investment?*

  No. Discounting short term capacity makes it an especially attractive proposition to shippers, particularly where it is unconstrained – as is the case with most of the GB network. However, such short term bookings i.e. within day and day ahead, are of extremely limited value to National Grid with regards to investment decisions. To further highlight the muddled thinking on discounting of capacity, it is our understanding that NG will only invest in response to an

incremental QSEC signal. Therefore anything less than a QSEC signal – i.e. monthly and daily capacity - provides no TO investment signal and should according to the SRMC rule attract a price discount.

- *How do our current charging arrangements interact with those in neighbouring markets? What is the impact of these interactions?*

  Recovering costs through commodity charging has been proven to distort cross border flows. This is evidenced by the need for NBP prices to exceed continental hub prices by at least the variable cost – typically in the order of 1.5p/th in recent times – in order for gas to flow to GB. This is more uncertain in the longer term due to impacts of mandatory bundling and any further integration under the gas target model.

Question 3: How do current arrangements give rise to these issues?

See above.

Question 4: In the event that there were to be minimal implementation of the Framework Guidelines/network codes as currently drafted, eg no subsequent changes at domestic points, what would be the impact?

At this stage of the review, the full impacts are difficult to assess. However, disregarding the principles of non-discrimination, the impacts of minimal implementation would include additional complexity caused by a dual system at interconnection points, and greater uncertainty for optimising UKCS production (with a knock on impact on GB tax revenues) if imports faced lower costs to access the market. Beyond that, it's very difficult to say at this stage.

Question 5: Are our goals for the review appropriate?

Yes, as far as they go. We support the review but want to ensure that future proofing is done to the greatest possible extent. For example, omitting connection charging and methodologies from the review in the light of shale gas developments would be a mistake.

Question 6: How could charging arrangements better meet the objectives set out in NGG's special standard condition A57 which sets out the objectives for NGG"s charging methodology?

No arrangements can hope to meet all of the relevant objectives equally. It might therefore be helpful to have guidance on the hierarchy in which objectives should be considered.

Question 7: Do the objectives set out in NGG"s special standard condition A5 remain fit for purpose? If not, how should they be changed?

We believe they generally remain fit for purpose.

Question 8: What other suggestions do you have for the objectives of our review?

The review should seek to minimise future charge uncertainty by seeking to future proof changing arrangements as much as possible at this stage. This must take account of all challenges and opportunities facing GB, including for example, onshore shale gas exploitation.

Question 9: What is your view on the timescale for our review?

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We believe it could be at least 6 months before all of the issues and their interdependencies are understood and documented. Subsequently, based on the evidence of timescales for other detailed reviews (e.g. Project TransmiT looking at electricity transmission charging is coming up for three years, and the gas emergency cash-out SCR is now two and a half year old) we believe that at least another 18 months must be allowed. Nevertheless, it will be crucial to ensure this work is completed such that it dovetails with the EU Tariff Network code.

Question 10: Bearing in mind the issues and objectives you have identified, what options should be explored to address these?

We wouldn't want to see anything ruled out at this stage.

Question 11: What are the pros and cons of your suggested option?

N/A

Please don't hesitate to contact me if you have any questions about this response.

Yours sincerely

Chris Wright

Commercial Manager