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Dear Andy,

Gas Transmission Charging Review – Call for Evidence

Thank you for giving SSE the opportunity to respond to the specific questions raised by Ofgem in relation to this call for evidence.
SSE agree that charging for Interconnector Points (Moffat and Bacton) must first and foremost comply with EU requirements. After this, guiding principles should ensure cost-reflectivity and promote competition and efficiency. As such transparency, stability and non-discrimination are important concepts in setting charges. The current GB domestic charging arrangements meet these objectives.

SSE strongly believe we should retain the current GB charging arrangements for domestic points and introduce the EU Framework Guidelines on Tariffs only to Interconnector Points. A precedent has been established in the electricity market where under GM ECM-26, Ofgem has allowed implementation of different charging arrangements for interconnectors and domestic points to comply with the requirements of the third package 714/2009.

ACER's interpretation of how revenues are to be recovered at Interconnector Points differ in two main ways from the current GB charging methodology:

1. Only capacity charges are allowed (commodity charges will not be allowed) and
2. Only prevailing costs will apply which means that fixed priced entry contracts obtained in previous QSEC auctions may be prohibited. Although this clearly presents a conflict with the right of contractual freedom /principle of legal certainty and legitimate expectations.

SSE does not believe it will be unduly discriminatory to apply different charging treatments to Interconnector Points from all other domestic entry and exit points as they are different under EU legislation by definition and in nature. In fact we believe that applying the EU Tariff Guidelines to **all** GB domestic points would:

1. conflict with the precedent established in electricity markets where Interconnectors have different charging arrangements from domestic users.
2. add uncertainty to investment costs and therefore be detrimental to security of supply.
3. increase the cost of importing gas to the UK and reduce certainty of imports arriving.
4. discriminate against customers with existing capacity bookings because cost recovery will be unduly loaded on them if commodity costs are removed.
5. lead to inefficient investment as users seek to bypass the NTS with their own infrastructure.
6. risk legal action over fixed priced domestic entry contracts being unnecessarily affected.

The above points are explained in more detail in response to question four.

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

National Grid NTS (NG NTS) have provided analysis that approximately half of capacity costs are recovered through TO commodity charges. This has occurred because:

1. over the network there is a known surplus of Entry capacity, due to declining UKCS gas production,
2. allowed revenue has increased and
3. day ahead and within day capacity can be purchased at a significant discount to the annual reserve price. In a previous decision, Ofgem deemed that the short run marginal cost of making existing capacity available was zero and therefore it was cost reflective to have a zero price for capacity that was purchased on a short term basis. SSE agreed with this principle.

NG NTS have provided analysis on how the commoditisation of the TO capacity charge has increased TO commodity costs by 1.4 p/th. However, it has not been demonstrated what the saving in capacity costs is and this analysis should be carried out to discover the net increment in cost. Arguably it is more cost reflective to pay for capacity on the day it is used through a commodity charge than booking capacity on an annual basis and only using it occasionally.

Looking to the future SSE believe more CCGTs will be built to replace coal and to provide support for intermittent renewables. The anticipated lower load factor of these will make the purchase of firm exit capacity an expensive fixed overhead. Whereas, the commoditisation of network charges has and will feed these costs directly into the marginal cost of power assisting with cost recovery and cost reflectivity.

SSE believe that in time the substitution of unsold capacity will encourage users to book capacity and lead to a rebalancing of recovery of revenue to capacity from commodity charges. SSE believe we should be wary of implementing changes to the charging methodology before other factors such as substitution have had time to provide stabilising feedback.

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

SSE are not unduly concerned with current charging arrangements, we think paying a commodity charge is more cost reflective than paying locationally differentiated annual capacity charges.

With regard to investment, SSE supports the current charging regime of being able to pay a fixed entry capacity cost at the time of making a Final Investment Decision through the QSEC auction. This removes uncertainty from a large cost component of any investment because the cost is known. Unfortunately, the EU Framework Guidelines on Tariffs for Interconnector Points will only allow prevailing charging. Therefore, if the EU Guidelines were to be extended to Domestic points this will introduce cost uncertainty and would further deter investment in gas storage, unconventional gas and LNG importation terminals, reducing security of supply.

With regard to providing investment signals to NG NTS the market has largely had the capacity it requires, when it requires it. SSE concerns going forward are based around the Planning Act and NSIP, interactions with EMR Capacity Auctions and PARCA arrangements under mod 452 for timely release of capacity, rather than charging under the current regime. From a legal perspective there is no need to change the current domestic charging methodology.

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

Ofgem and NG NTS provided detailed analysis at the stakeholder event on 8 th July which demonstrated that gas flows were largely flowing through the IUK in a market efficient manner, once the transportation charging differentials had been taken into account. The relatively low utilisation rates can be explained as the IUK is one of the marginal sources of supply, although it was demonstrated in the Winter of 2013 that full capacity can be utilised if the market conditions dictate. This indicates that the charging arrangements between Belgium and GB are not a barrier to efficient trade.

The BBL flows did not appear to respond to market prices to the same extent. This might be worth further investigation, but we suspect gas quality and contractual obligations drive the current use. We note all annual forward capacity has been sold for 2013, which does not indicate any issue with making capacity available. Overall, this would seem to contradict the assertion that the commoditisation of capacity charges has deterred gas imports to GB and threatens security of supply.

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

See response to question1 and 2.

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?

SSE notes that HM Government Transposition Guidelines on Implementation of EU Directives recommends only minimum implementation to minimise burdens. SSE strongly advocates minimal implementation of the EU Framework Guidelines on Tariffs to only Interconnector Points. Ofgem has recently decided that Interconnector Points in the electricity market are granted different charging treatment from domestic generation (entry) and demand (exit) points[1]. SSE would encourage Ofgem to consider the same arguments and the legal precedent set to ensure minimal implementation of the network codes in gas. This will help avoid inequitable treatment and undesired negative interactions between the two commodity markets.

SSE believes we should retain our current charging arrangements for domestic points. This will minimise disturbance to the UK gas market, unintended consequences and avoid security of supply concerns as outlined below:

1. With regard to investment, SSE supports the current charging regime of being able to pay a fixed entry capacity cost at the time of making a Final Investment Decision through the QSEC auction and future PARCA process. This removes uncertainty from a large cost component of any storage/LNG/Shale gas investment because the cost can be fixed. Unfortunately, the EU Framework Guidelines on Tariffs will only allow prevailing charging. This would introduce entry cost uncertainty and would further deter investment, reducing security of supply.

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[1] Use of System Charging Methodology Modification Proposal GB ECM-26 “Review of Interconnector Charging Arrangements”, CUSC CMP202 and BSC P278.

If it is eventually determined that fixed priced capacity contracts for domestic entry points must pay the prevailing price, the provision must be made to allow termination of the contracts due to material change of law.

2. The application of the same charging arrangements to domestic and Interconnector Points would almost certainly create unforeseen consequences and would create further uncertainty and distortions. To attract investment GB needs stability and certainty of charges, constant change does not provide this.
For example, if commodity charges could not be applied to recover domestic capacity revenues and if the existing rule of a zero charge for prompt use of capacity was maintained:

- very limited revenue would be recovered in a year. The next year, the K factor would increase dramatically to ensure recovery of the previous year's revenue. These revenues would be recovered on a shrinking population of non-prompt capacity bookings as users sought to avoid paying elevated charges. Ultimately most of the capacity costs would be paid by a very small population base as most users switched to prompt /offpeak products. This basis of charging will not be cost reflective, will be unstable and does not avoid discrimination. This high cost will discourage the firm booking of capacity and the importing of gas to the UK thereby reducing security of supply and increasing the likelihood of a gas deficit emergency. For these reasons Ofgem is urged to introduce minimal implementation of the Tariff Framework Guidelines for Interconnector Points.
- Certain customers have low load factors compared with competitors. i.e. peak generation plants, peak storage plants and these customer groups will unduly subsidise customers with higher load factors, effectively paying through capacity charges the losses and associated variable costs of the other customers. We consider this to be discriminatory. It will have a security of supply impact both on gas, through gas storage and in power because of lack of economic viability of peak plant. Without the ability to commercially operate peak plant in gas and power the ability to provide support for intermittent renewables will be constrained along with the ability to meet carbon reduction targets.

3. If capacity charges become very high and no short haul charges are available due to there being no commodity costs then one would expect to see private pipelines constructed, direct from beach to exit point to avoid the NTS. This will ultimately be inefficient for GB plc and will ensure greater costs are imposed on to remaining NTS customers.

4. We understand from the Framework Guidelines that storage sites will be eligible for special treatment. This could extend to not paying capacity charges, as is the case in other European states. Gas Storage clearly avoids system reinforcement by supplying gas on peak days and injecting gas on low demand days. NGG should provide analysis of how storage contributes to avoiding network reinforcement. It should establish what revenues are recovered and what NTS investment would be required if storage did not exist.

Question 5: Are our goals for the review appropriate?

SSE understand the goals of this review to be:

1. setting the right incentives for all parties,
2. ensuring that charges are compliant with EU network code requirements,
3. avoiding any undue distortions between domestic and interconnector points.

SSE are not clear by what is meant by the first point and further clarity would be helpful here. It is unlikely that a single solution will be acceptable to all industry participants due to the different business models of storage, generation, supply, E&P and interconnectors . We agree with the second and third objectives.

Question 6: How could charging arrangements better meet the objectives set out in NGG‟s special standard condition A5[7] which sets out the objectives for NGG‟s charging methodology?

SSE consider that the EU framework guidelines are mandatory and the main objective is to ensure gas flows across Europe unimpeded by national practices. The UK has had one of the most liberalised gas markets and has been able to import and export gas without distortion. Therefore, we believe we should do the minimum to meet the requirements of the Framework Guidelines and avoid unintended distortions to the UK gas market.

Ofgem should consult on an appropriate priority listing of the objectives such that a hierarchy of objectives can be agreed.

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?

SSE believe they remain fit for purpose.

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

No others at this time.

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

Ofgem are premature to start this call for evidence now because the EU Tariff Framework Guidelines for interconnectors are not finalised and do not have to be in place until October 2017. SSE consider that we should wait until the EU process has been through ENTSOG Drafting because of the potential for interpretational consequences and change. SSE also consider that because of the materiality and potential for unintended consequences of the wider domestic tariff review this may ultimately need to follow a different time line from the EU Tariff Framework.

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

In priority order, areas for further analysis to be reported back to the industry by National Grid Gas are:

1. It is SSE’s understanding of the Framework Guidelines on section 3.7 Implementation, that two charging methodologies must be developed and all information published. It is SSE’s opinion that the two most suitable charging methodologies for the UK are Postage Stamp and Distance to Virtual Point. SSE look forward to being able to compare and contrast the different charging methodologies and their associated revenues and variance of charges.
2. Quantify the current revenues recovered from storage and quantify how much storage contributes to avoided network reinforcement. Establish whether these charges are appropriate, bearing in mind that storage is allowed different charging treatment in the Framework Guidelines, including zero charges.
3. The EU tariffs framework will allow 1. removal of the prompt discounts for day ahead and within day products such that the annual reserve price was charged and 2. Interruptible products will be charged on the basis of likely interruption. Interruption very rarely occurs and effectively a firm price could be charged. If these changes were made for all entry and exit capacity charges how much revenue would be recovered from capacity charges and what impact would this have on TO commodity charges for domestic points.

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

SSE believe there is more at risk to GB by over extending the minimal implementation of the Framework Guidelines. We have outlined a number of charging options that will meet the EU requirements and ensure no cross subsidy. The options are listed below:

1. Retain the current GB charging arrangements for domestic points and introduce the EU Framework Guidelines on Tariffs only to Interconnector Points.
2. Investigate zero capacity charging for storage sites.
3. Investigate the withdrawal of zero charges for prompt capacity products.
4. Allow the termination of long term capacity booking contracts, once the Tariff Framework Guidelines are in place if they extended to all points.

If you would like to discuss any of the points raised please do not hesitate to contact me.

Yours sincerely

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Regulation & Strategy