All interested parties and stakeholders

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Proposed modifications to National Grid Gas plc's Licence to terminate Permit Arrangements and adjust the revenue earned for the period 1 April 2013 – 31 March 2015

Today we[1] have published a section 23 notice of modifications of Special Licence Conditions 1A, 2D, 5F and 5G of National Grid Gas plc's transmission (NGGT's) licence. The modification would terminate the Permit Arrangements and adjust the revenue earned from them for the period 1 April 2013 – 31 March 2015.

This letter contains our final proposals to make changes to NGGT's licence relating to the use of permits to vary lead times for the provision of incremental gas transmission capacity. Permits are redundant following the introduction of alternative commercial arrangements for delivering incremental capacity, Planning and Advanced Reservation of Capacity Agreements (PARCAs).[2]

On 8 December 2014, we made changes to NGGT's licence, and approved changes to the Uniform Network Code (UNC) to introduce PARCAs. The revised licence conditions came into force on 31 January 2015 and the changes to the UNC came into force on 2 February 2015. We consulted in November 2014[3] on a proposal to terminate the Permit Arrangements and to adjust the value of the permits allocated to NGGT for the period 1 April 2013 to 31 March 2015 and proposed draft licence text. This letter contains our final proposals to make changes relating to the use of permits to vary lead times. We are now seeking views on the proposed drafting of the licence changes we are proposing to make.

This is a statutory consultation on our proposed licence modifications. These are set out in Annex A of the Notice, accompanying this document.[4]

Summary

After careful consideration of the responses against our principal objective and statutory duties, our final proposal is to:

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[1] The terms 'the Authority', 'Ofgem' and 'we' are used interchangeably. The Authority is the Gas and Electricity Markets Authority. Ofgem is the Office of the Gas and Electricity Markets Authority.
[2] Planning and Advanced Reservation of Capacity Agreements decision https://www.ofgem.gov.uk/publications-and-updates/decision-licence-changes-implement-planning-and-advanced-reservation-capacity-agreements
[3] Informal consultation on terminating permits https://www.ofgem.gov.uk/publications-and-updates/proposal-terminate-use-permits-arrangements-national-grid-gas-transmission%E2%80%99s-licence-and-adjust-revenue-earned-permit-arrangements-period-1-april-2013-%E2%80%93-31-march-2015
[4] Notice accompanying this document https://www.ofgem.gov.uk/ofgem-publications/93720/noticeofproposedmodificationstonationalgridgasplcslicencetoterminatepermitarrangementsandadjustttherevenueearnedfortheperiod1april2013-31march2015.pdf

- remove special licence conditions from NGGT's gas transporter licence to terminate the Permit Arrangements; and
- adjust in the licence the value of permits allocated to NGGT. This means a reduction of £8.35m to the total allowance for 1 April 2013 – 31 March 2015, reducing it from £32.39m to £24.04m.

NGGT's gas transporter licence includes an incentive mechanism, called Permits Arrangements, which allows it to manage the delivery of incremental network capacity. When a shipper signals for incremental capacity at an entry auction or exit allocation window, NGGT can, if needed, use its permits to extend the lead time required by the licence to deliver it. Permits have an associated financial value; any permits NGGT does not use can be cashed in by NGGT.

In 2012, as part of its updated business plan for RIIO-T1, NGGT proposed new arrangements for the release of incremental capacity, known as PARCAs. These would have removed the need for permits. However, these were not developed enough to be implemented for the start of RIIO-T1. Therefore, as a contingency, we extended the Permit Arrangements for the first two years of RIIO-T1. Following consultation, we issued NGGT with a permit allowance of £19 million[5] for 2013/14 and £13.39m for 2014/15.[6] A detailed background to the Permit Arrangements and an explanation of how they work in practice can be found in the November 2014 consultation.[3]

PARCAs are now in force, as confirmed in our Quarterly System Entry Capacity (QSEC) letter,[7] and national transmission system (NTS) users needing funded incremental obligated capacity will request it directly from NGGT.[8] This makes the Permit Arrangements redundant.

We indicated our proposal to terminate the Permit Arrangements in our consultation of 17 March 2014[9] when we said: "If and when new commercial arrangements are introduced we will consider what an appropriate and fair treatment of NGG's permit allowance is". We confirmed this in our decision of 28 April 2014[10] to extend permits to 31 March 2015. We consider it is appropriate, in order to protect the interests of existing and future gas consumers, to reduce the revenue earned from permits to reflect the reduction in risk NGGT faces at the March 2015 QSEC Entry Capacity auction. The introduction of PARCAs means permits are not needed for this auction, because funded incremental obligated capacity will not be offered.

On 10 November 2014 we published a consultation setting out our proposed policy and proposed changes to the special conditions of NGGT's licence to terminate the permit arrangements and adjust the revenue earned from them. This consultation closed on 22 December 2014. Respondents generally supported our proposals in principle, but gave feedback on particular details of the proposed policy.

Consultation and responses

We received three responses to the November 2014 consultation, from RWE, Energy UK and NGGT. These have been published on our website.[3]

General points

[5] RIIO-T1 Final proposals for permit arrangement for year 1 (table 4.1 p.37): https://www.ofgem.gov.uk/ofgem-publications/53599/1riiot1fpoverviewdec12.pdf
[6] Direction on extending permits from 1 July 2014 – 31 March 2015: https://www.ofgem.gov.uk/publications-and-updates/modification-direction-permit-arrangements-provision-incremental-capacity-licence-national-grid-gas-plc
[7] https://www.ofgem.gov.uk/publications-and-updates/agreement-nggt%E2%80%99s-proposed-approach-incremental-capacity-march-2015-qsec-auction
[8] Incremental capacity that can be met through using available unsold baseline capacity and capacity substitution can still be made available through the QSEC entry capacity auction or exit capacity application windows
[9] https://www.ofgem.gov.uk/ofgem-publications/86584/140317riioy2permitscoverletter.pdf
[10] https://www.ofgem.gov.uk/ofgem-publications/87455/140415permitscoverformoddirfinal.pdf

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RWE and Energy UK both expressed concern that, without an adjustment, NGGT would receive a "windfall", with Energy UK going further and disagreeing with the original April 2014 decision to allocate 2014/15 permit allowances in the first place.

NGGT expressed disappointment that we had not included in the licence our approach to adjusting permits allowances when we extended them in July 2014, and that, as a result, a "retrospective" adjustment would be necessary. Although it argued that we had not provided upfront regulatory certainty, it supported an adjustment to the value of the permits scheme to reflect the reduced forward risk directly associated with the introduction of PARCAs.

Timing and interaction with PARCA implementation

RWE and NGGT expressed concern that all the arrangements for PARCAs might not be in place in time for the March 2015 QSEC auction. RWE requested clarification on when PARCAs would be considered to be "introduced" as the amended Capacity Methodology Statements were outstanding. NGGT requested that we confirm our agreement with its intended approach to apply the spirit of PARCAs, by not making Funded Incremental Obligated Entry Capacity (as that term is defined in the NGGT licence) available at the March 2015 QSEC auction.

Revenue adjustment

All respondents agreed with our proposal that some adjustment should be made to reduce the permit allowance awarded to NGGT, but did not agree on the exact amount by which the adjustment should be made. Our consultation suggested five possible options for adjusting the revenue earned from permits by NGGT from three broad categories:

- two time-related options, producing reductions of £7.2m (1a) and £2.98m (1b)
- two options based on whether the permits were allocated for entry or exit capacity. These produce reductions of £6.695m (2a) and £3.96m (2b)
- an option based on the permits committed for use, resulting in a reduction of £8.35m (3).

The consultation asked respondents to indicate their preferred approach from these or propose and explain the reasons for an alternative approach.

Time-related options

RWE did not support either of the time-related options, stating that pro-rating allowances would not be appropriate.

NGGT said that while it agreed that the risk of receiving an incremental capacity signal was not uniform across the formula year, it was ever present as it could receive a signal through an ad-hoc process or through Advanced Reservation of Capacity Agreements (ARCAs). NGGT also argued that a time-related option should apply only to the additional £13.39m permit allowance for 2014/2015 and that the starting point for the time related adjustment should be April 2014 and not July 2014. NGGT provided an alternative option based on these views which would imply an adjustment of £2.23m but indicated that this was not its preferred option.

Adjustment related to whether permits were allocated for entry or exit capacity

RWE said that the projected data, provided by NGGT, on which the allowances were based, has proved to be inaccurate. RWE also thought that it was "inappropriate to arbitrarily split based on entry and exit capacity".

NGGT did not consider option (2a), an arbitrary 50/50 split of the additional permit value, to be a fair, reasonable or appropriate reflection of the reduced risk attributable to the introduction of the PARCA arrangements.

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NGGT preferred option (2b), £3.96m. NGGT noted that this option would correspond to our subjective assessment first published in February 2014[11] of NGGT's potential need for permits in relation to entry and exit capacity, based on projected data it provided in October 2013. NGGT considers it unfair to describe its projected data as "not proven to be accurate thus far". NGGT also noted that the projected data supplied to us had been scaled down from its own assessment of all potential incremental signals.

Permits committed for use

RWE's preference was for option (3), £8.35m, on the basis that "it attempts to reduce the permits allowance based upon NGGT's future reduction in risk faced".

Energy UK's preference was "to recover as much of permits allowance as [we] legitimately can". In the absence of a suggested alternative, we interpret this as support for option (3).

NGGT did not favour this option. It argued that a "historic snapshot" of permits "played" for the July 2014 and July 2013 Enduring NTS Exit (Flat) capacity windows did not give a representative picture of its ongoing incremental capacity risk. It also noted that the mechanism for calculating the cash-out value of permits did not make any distinction between permits played (but not used) and those not played at all – all unused permits were cashed out.

NGGT believed that this option did not represent a subjective assessment of the forward reduced risk directly attributable to the introduction of PARCAs ahead of the March 2015 QSEC.

Proposed licence modifications

We proposed to amend special conditions 1A, 2D, 5F and 5G of NGGT's licence as shown in Annex 1 of this consultation. The proposed changes include the removal of text relating to the use of permits and the variation of lead times following the introduction of PARCAs. They also show the proposed changes to the revenues earned from Permit Arrangements if we decide to adjust the revenue earned by NGGT from permits. We asked respondents for their views on our proposed licence text drafting.

RWE supported our proposals and NGGT disagreed with them. NGGT said that the proposed licence text drafting went beyond the issue on which we were consulting, the adjustment of the revenue earned from Permit Arrangements, and was of the view that the licence text should not adjust the mechanics of the scheme or the permits available. It suggested alternative licence text, just replacing the value of permits in Special Condition 2D.1 and 2D.23 by the relevant amount, which it argued would ensure that permits would still be accounted for correctly up until the proposed licence changes come into effect.

Our views

General

We note that, to date, NGGT has not used any of the permits it has available to extend default lead times and that this may appear as NGGT making a "windfall". However, it is in the nature of forward-looking allowances that these may turn out to be more than required, or less than required. Under the incremental capacity arrangements prior to the introduction of PARCAs, NGGT held the lead-time delivery risk including the risk that its permit allowances would be insufficient in total, and the risk that permits used on one or more entry or exit points would be insufficient. We do not think that it would be right to retrospectively adjust allowances for risk, after the period in which that risk was borne and managed by NGGT.

[11] https://www.ofgem.gov.uk/ofgem-publications/85902/140205riioy2permitscoverletter.pdf we withdrew this consultation and issued a new consultation in March 2014 that contained the same subjective assessment.

In extending the Permits Arrangements, we based NGGT's allocation on our subjective assessment of data on the potential projects submitted by NGGT. NGGT's projected data represented a pragmatic view of the risk it faced. We allocated an amount lower than implied by NGGT's submission, to increase NGGT's incentives to keep within its allowance. While it was possible that NGGT would not face any incremental capacity signals, it was also possible that it could face more than it expected.

We would not normally reduce revenue associated with an incentive as this can cause regulatory uncertainty. However, in this case the risk to which the incentive was linked – future signals for incremental capacity – will in future be managed differently. PARCAs remove a future risk that would otherwise have existed under the previous licence terms. We note that all respondents agreed with the principle of adjusting for the reduction in future risk. We do not consider that a decision by us to adjust the permit allowances now would have any retrospective effect on NGGT. NGGT's permits revenue is not related to any output, and the revenue adjustment will not affect NGGT's obligations or its funding of them.

We consider this case to be exceptional and perhaps unique, and our proposals are specific to these unusual circumstances. The Permit Arrangements were extended as a contingency for the delays in developing PARCAs in time for RIIO-T1. We were clear in the RIIO-T1 Final Proposals[12] that the Permit Arrangements were an interim measure. We also made it clear in our consultations to extend permits that "if and when new commercial arrangements are introduced we will consider what an appropriate and fair treatment of NGG's permit allowance is".

We believe our proposal to adjust NGGT's revenue from permits is justified and in line with NGGT's changing need for permits.

Timing and interaction with PARCA implementation

The revised conditions of NGGT's licence to introduce PARCAs came into force on 31 January 2015 and the changes to the UNC came into force on 2 February 2015. We approved the amended Capacity Methodology Statements on 27 February 2015. We have responded[13] to NGGT's proposal to apply the spirit of PARCAs and have confirmed that we agree with its intended approach not to make Funded Incremental Obligated Entry Capacity available through the March 2015 QSEC. NGGT issued its invitation letter to the March 2015 QSEC auction, reflecting this agreed approach, on 16 February 2015.

Revenue Adjustment

Time-related options

We note NGGT's view that if we choose this approach, we should apply the time-related option to the additional allowance of £13.39m, and that this approach would be more consistent with options (2a), (2b) and (3) where no adjustment to the allowance for the period 1 April 2013 to 31 March 2014 is proposed. We do not agree that the starting point for the adjustment should be 1 April 2014 as the additional £13.39m did not become effective until 1 July 2014.

We also do not agree with NGGT that the £13.39m is subject to an ever present risk. The £19m allowance made for the period 1 April 2013 – 31 March 2014 implicitly included an allowance for the risk of incremental signals being received via an ad-hoc process or ARCAs. NGGT presented no evidence in its submission for the additional allowance of any additional risk from these allocation processes. The £19m of permits "rolled over" into the second period. We consider that this included an adequate provision for NGGT to manage the risk of incremental signals arising from ad-hoc processes or ARCAs during the second period.

[12] https://www.ofgem.gov.uk/ofgem-publications/53599/1riiot1fpoverviewdec12.pdf
[13] https://www.ofgem.gov.uk/publications-and-updates/agreement-nggt%E2%80%99s-proposed-approach-incremental-capacity-march-2015-qsec-auction

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However, we recognise that none of the time-related options (including the alternative proposed by NGGT) are favoured by any of the respondents. We also consider that a time-related adjustment would not reflect the reduction in risk facing NGGT. This reduction is related to NGGT not needing to manage the risk of the specific event of the March 2015 QSEC auction.

Adjustment related to whether permits were allocated for entry or exit capacity

We agree with RWE and NGGT that option (2a) is not appropriate as it is based on an arbitrary split.

Our allocation of permits was not intended to tie allowances to particular entry or exit projects, but to provide an envelope within which NGGT could manage its risk. However, it is possible to use the split we made in the assessment underpinning our allocation to estimate the risk faced by NGGT from the March 2015 QSEC as is proposed in option (2b), (£3.96m). We recognise that the project data submitted by NGGT, upon which we based our subjective assessment, represented a pragmatic view of the risk it faced and also that NGGT was the best placed to provide this information. However, it is apparent that, to date, NGGT has not needed to use any of its permits to extend default lead times. This raises questions about the suitability of our assessment as a proxy for NGGT's prospective risk from the March 2015 QSEC. We also consider that we have more up to date information (in the form of NGGT's commitments to use permits at the July 2014 Enduring NTS Exit (Flat) capacity window) to allow us to estimate the prospective risk faced by NGGT.

Permits committed for use

We accept that option (3) is based on a historic snapshot of NGGT's decisions in relation to its exit capacity risk in July 2014.

However, we consider that the amount of permits "played", and of those not played, are relevant facts that we should not ignore. These facts are more up to date than the projected data provided by NGGT, and the subjective assessment we made based on that data.

We note that in each of the recent years immediately preceding this, NGGT has implicitly indicated it would commit all its permits at the March QSEC auctions (as derived from its proposals to vary lead times at specific entry points). In the absence of PARCAs, if the trend of recent years continued in the current year, then most if not all of NGGT's permits would be played at the March 2015 QSEC auction.

We agree that referring to permits committed for use may be less subjective on our part than the other options. This option would allow us to base the revenue adjustment on NGGT's most recently published balanced (and subjective) assessment of risk.

We consider that the permits committed for use by NGGT may represent a more valid basis to estimate NGGT's prospective risk (from the March 2015 QSEC), than our subjective assessment in option (2b).

Proposed Licence modifications

NGGT's counter proposal would achieve the revenue adjustment, but would not remove some of the text made redundant by the introduction of PARCAs. We consider that as the Permit Arrangements are superseded by PARCAs, the policy to terminate the Permit Arrangements is predetermined. Our proposal terminates the use of permits and removes redundant licence text.

Our final proposal

We have assessed the options against our principal objective as set out in section 4AA of the Gas Act 1986 (the Act) and against our general statutory duties.

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We have also considered carefully the arguments made in the consultation responses. In light of our principal objective and the consultation responses, we consider that it would be most appropriate to adjust NGGT's revenue earned from permits based on option (3): *Permits committed for use*. This means a reduction of £8.35m to the total allowance for 1 April 2013 – 31 March 2015, reducing it from £32.39m to £24.04m. We believe that the implementation of this option would be best calculated to further the principal objective.

Therefore we propose to implement the changes to the special condition licence text as consulted on in the November 2014 consultation.

Reasons for our decision

The Act requires us to protect the interests of existing and future gas consumers. In making our decision, we have taken into account which option is "best calculated" to protect the interests of existing and future gas consumers:[14]

- having regard to the need to secure reasonable demands for gas are met; and
- having regard to the need to secure NGGT is able to finance its licensable activities.

Protecting the interests of consumers

Having carefully considered the responses to our consultation, we think that it is in consumers' interests to adjust NGGT's revenue by an amount based on the option which best estimates the reduction in its risk.

We consider that the time-related options and those where the adjustments relate to whether permits were allocated for entry or exit are poor indicators of this reduction in risk as explained above.

We believe that a reduction of £8.35m (option (3) based on permits committed for use by NGGT at the July exit window, is less subjective on our part, is not excessive, and is the option which best estimates the reduction in NGGT's risk.

Having regard to the need to secure reasonable demands for gas are met

We do not consider that our decision will have any material effect on this consideration.

Having regard to the need to secure NGGT is able to finance its licensable activities

Our decision to adjust the revenue that NGGT can earn from Permit Arrangements does not affect NGGT's obligations or its funding of those obligations. The reduction is related purely to a reduction in prospective risk.

Next steps

This statutory consultation on proposed amendments to special conditions of NGGT's licence is open for responses on or before 1 April 2015. Once we have considered responses, we aim to make a final decision on whether to implement the reforms during April 2015.

If we decide to make the amendments, licence holders, trade bodies representing licence holders and Citizens Advice and/or Citizens Advice Scotland will have 20 working days to decide (from the first working day after our decision is published) if they want to appeal against the reforms to the Competition and Markets Authority. Subject to the appeals process, it is intended that the reforms would start to take effect in June 2015.

If we decide to implement the changes to the special conditions of NGGT's licence we propose they would come into effect at the end of the minimum statutory period for implementation. This means NGGT would need to ensure it was compliant with the new arrangements from

[14] As required by sections 4AA(1) and 4AA(2) of the Act.

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the date the licence modifications become effective, which we are proposing would be 56 days after the day our decision is published.

Responding

Any representations to the proposed licence modifications must be made on or before 1 April 2015 to: David Reilly, Gas Transmission policy, Ofgem, Fifth Floor, 9 Millbank, London, SW1P 3GE or by email to: david.reilly@ofgem.gov.uk.

Please note that any responses to the consultation will be placed on our website unless marked as confidential. We prefer to receive responses by e-mail.

If you have any queries regarding the content of this letter, please contact David Reilly by using the email address above or telephone 0203 263 9648.

Yours faithfully,

Andy Burgess
Associate Partner, Transmission and Distribution Policy

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