Gas Transmission Charging Review: Part II our assessment of potential impact Ofgem Consultation

Consultation Response

Energy UK is the trade association for the energy industry. We represent over 80 members made up of generators and gas and electricity suppliers of all kinds and sizes as well as other businesses operating in the energy industry. Together our members generate more than 90 per cent of the UK's total electricity output, supplying more than 26 million homes and investing in 2012 more than £11billion in the British economy.

Energy UK welcomes the opportunity to provide comments to this consultation, we appreciate the stakeholder engagement Ofgem has undertaken to date and have actively participated in this.

We have some general concerns and observations that we detail below before providing comment against the more detailed questions.

Energy UK is concerned that the goalposts of the Gas Transmission Charging Review (GTCR) seem to have changed since it was launched. Initially the aim was to consider reforms to the GB entry charging regime in the context of the still to be finalised European Tariff Network Code (TAR NC) and whether these should be implemented at interconnection points (IPs) only or at all entry points. At the time the TAR NC expected most charges to be recovered from capacity rather than commodity charges. Ofgem and National Grid (NG) lobbied to allow for a commodity charge to be permitted for the recovery of allowed revenue. The expectation was that the review would help to inform a GB position for participation in the comitology process. We note a draft position for comitology is absent from the consultation.

In addition the draft TAR NC was changed in a number of ways between the initial draft for consultation in summer 2014 and that at the time of the stakeholder support process in November 2014. Ofgem's proposals appear more consistent with the summer draft.
It is also the case that there could be further substantive change to the TAR NC before it is finalised. It is therefore difficult to comment on the proposals without more understanding as to how they may interact and need amendment to be compliant with the final TAR NC. In this context, we strongly recommend that Ofgem should avoid making a final decision on the GTCR until the TAR NC is finalised.

There are a number of themes in the document that do not seem to be substantiated:

Historical Network Costs:
Ofgem's letter of 12 December 2014[1] seems to suggest that the cost of existing assets *cannot be attributed to specific users*, even though all users benefit from the existence of the network, whilst also commenting that these costs are *increasingly being socialised*. The latter being an issue in that users who do not flow do not make a contribution. We do not really understand why this is a problem since Ofgem acknowledges that the costs cannot be targeted and a commodity charge does at least require

[1] https://www.ofgem.gov.uk/ofgem-publications/91919/gtcrpolicyposition.pdf see section on inefficient allocation of historical network costs

a contribution when gas flows. Whereas a capacity based floating charge would require a contribution even if the network is not used but capacity is secured to provide the optionality to flow. In largely unconstrained systems we do not see a particular problem with commoditisation of historical costs.

We also note that Figure 3 on page 11 appears to show that auction revenue has been relatively stable in recent years whilst NG allowed revenue has risen substantially. Hence the latter is also responsible to some extent for the increase in commodity charges alongside a move to short-term booking which Ofgem recognises is entirely rational[2].

It may be helpful to consider which locations / pipelines still have substantial asset value that is yet to be depreciated. We are aware from the proposal to decommission a feeder from St Fergus for potential conversion for CO_2 transportation that some pipelines have low residual value.

If the geographic distribution of assets with substantial remaining value is evenly distributed then the idea of locational recovery of historical costs may not be based on true value. However even if the distribution of assets with substantial remaining value is in discrete locations then it may still be appropriate to socialise these costs since we still have a shallow connection policy and as Ofgem states all users benefit from the existence of the network.

<u>Short-term capacity booking behaviour:</u>
There is an assumption in the modelling that shippers will continue to book the same quantity of short term capacity as now unless the price is at a premium to the standard daily rate. This is a major flaw in the analysis since any payment >0 for capacity currently purchased to provide optionality for within day trading is likely to require shipper purchasing strategies to be reviewed. This assumption seems to lead to the total ‘cost’ of capacity being less than now since the floating charge will be spread over unchanged total capacity holdings. However we would expect shipper bookings to change so that this is unlikely to be the case.

<u>Short-term bookings affecting operational decisions:</u>
There is an assumption that if short term bookings were closer to flows then this would assist NG’s operational decisions and that this contributes to efficiency in the short run. Ofgem also notes that the cost to NG of a shift to short term bookings is not insignificant[3]. We request further information on these costs and on how NG uses short-term capacity bookings to inform operational decisions, our understanding is that operational decisions are informed by nominations and OPN and DFN submissions. If additional information is required to support operational decision making then we would welcome further industry discussion of this topic.

Ofgem refers to *‘optimal use of the network*’[4], it would be helpful to understand what this would be, so we can understand why the current use of the network is not considered optimal.

<u>Capacity booking and investment signals:</u>
The document seems to refer to the use of capacity bookings in informing investment[5] whereas our understanding is that the release of incremental capacity will require a PARCA (This is described in paragraph 3.82). Other non-load related investment such as the compressor strategy will use a wider range of data including future flow scenarios alongside capacity booking data.

CHAPTER 2: Explanation of our proposed changes to the charging regime
Question 1: What are your views on our proposed changes?

Energy UK welcomes the continued recognition of short-run marginal costing, this has been a long established principle in the GB regime and a significant move away from this would require extensive justification. We believe there are benefits in continuing with discounts for short-term capacity to

[2] Paragraph 1.17 of consultation document
[3] Paragraph 2.7 of consultation document
[4] Paragraph 1.29 of consultation document
[5] Paragraph 1.24 , 1.30, 4.37 of consultation document

facilitate short term trading and support liquidity at the NBP and increase in the costs of this optionality are likely to have a detrimental impact on liquidity.

We welcome the proposed treatment of storage that will ensure that storage does not pay the floating capacity top-up charge. This will maintain the existing treatment of storage users such that they are not exposed to commodity charges twice. We believe this is appropriate as storage users already pay to enter /exit the network when using storage. Therefore the proposal maintains the relative existing treatment of users of storage.

We welcome the decision not to apply indexation to historical QSEC bookings, we believe any benefits are outweighed by the complexity introduced and as such indexation does not merit further development

However it is difficult to establish a view on the whole package or proposed changes in isolation from a better understanding of how these proposals fit with the TAR NC which is yet to be finalised. It is also the case that these proposals are not yet sufficiently detailed to fully understand the likely impact. Whilst we agree it is appropriate to allow industry to work up the detail of the proposals, this will be challenging, given the constraints of these proposals a more holistic review would be appropriate. The process going forward should allow scope to reconsider the proposals if further analysis or the final version of the TAR NC supports this.

There are a number of elements missing from the proposals:

- Interaction with the shorthaul tariff review
- Interaction with current charging UNC modification 0517 and variants
- How capacity at the Easington terminals will be apportioned between storage and non-storage points, since the former will not pay the floating capacity charge.
- The legal position with respect to existing bookings.
- The process for forecasting short-term bookings especially at the introduction of the arrangements.
- The risk of increased volatility in entry charges.
- How and when under / over recoveries should be managed.
- The end of the separation of TO and SO revenues as required by the TAR NC.

Question 2: Do you agree with our rationale for rejecting the alternatives? If not, please explain why.

Ofgem's rationale for rejecting alternatives is outlined in a few lines on page 20. This does not provide comfort that Ofgem has undertaken a detailed exploration of alternative solutions. The option of implementation at IPs only which was supported by many stakeholders as a sensible first step to achieve compliance with the TAR NC is dismissed because the current regime has flaws, however we challenge whether many of the features Ofgem consider to be flaws, either exist at all or are sufficient to warrant such a significant change to the regime at this time.

An issue that is not explored is whether the capacity products that will be available at IPs should also be made available at GB domestic points too. It seems rather disjointed to not have the same products if the charging regimes are to be aligned.

CHAPTER 3: Impact assessment of these proposals

Question 1: Do you think we have identified the relevant quantitative impacts?

Ofgem identifies the quantitative impacts to be the level of entry transmission charges and their distributional impact on users. We agree that these are relevant.

Question 2: Do you think we have modelled the impacts appropriately?

Energy UK recognises that modelling the potential changes to the charging regime is a challenging and complex task and we welcome Ofgem's efforts in this respect. However whilst this can provide some insight into the potential impact of charging policy decisions it cannot reasonably be expected to reproduce shipper responses to these changes and therefore extreme caution should be used before concluding that changes give rise to benefits or otherwise.

An obvious example is where short-term capacity bookings remain constant so long as there is a discount to the reserve price, we do not think this is a credible assumption and we are concerned that the absence of sensitivities to this demonstrates a lack of rigour in the analytical method applied.

Furthermore there is no exploration of possible new sources of supply that may come on line over the assessment time horizon. Whilst the future cannot be known with any certainty, scenarios could be used to explore a range of possibilities.

We therefore consider that the outputs of the modelling have limited value.

Question 3: Do you think we have identified the relevant qualitative impacts?

Energy UK agrees that it is important to recognise the limitations of the modelling[6] and consider the qualitative impacts too.

We agree that entry charges can affect cross border but it is not self-evident that charges will be lower under the new regime, particularly since the cost of holding capacity for optionality will increase and the impact on the shorthaul tariff has not been explored.

We have commented above on the short-term bookings affecting operational decisions and the use PARCAs to support incremental capacity release and investment were required. We do not consider Ofgem's arguments in relation to these points support the case for the proposed reforms.

With respect to investment by third parties, say an LNG terminal, it is difficult to see how such investment would be encouraged when it will face higher costs when not flowing gas.

Question 4: Do you have any further evidence of the potential impacts of our proposed changes not covered by our analysis?

Energy UK would like to refer back to the comments made above under the Historical Network Costs sub-heading in relation to NG RIIO allowed revenue, whilst this was identified as being out of scope it would seem to be responsible at least in part for the under-recovery of allowed revenue so should not be immune. So a more detailed exploration of inflation adjustments and depreciation allowances would be helpful to better understand the trends in allowed revenue.

The impact on the economic value of long term gas supply contracts supported by long term entry capacity bookings which would see an additional fixed cost not foreseen at the time the contracts were agreed should also be considered.

Consistency with the TAR NC is also a key issue and we would expect these initial proposals to be considered in the light of the final code which is not expected until the end of the year at the earliest. With this in mind, we strongly urge Ofgem to avoid making a decision on the GTCR until the TAR NC is finalised

CHAPTER 4: Assessment against our objectives

Question 1: Do you agree with our assessment of how our changes would align with our principal objective and statutory duties?

[6] Paragraph 3.15 of consultation document

No, we do not think that Ofgem has undertaken a thorough assessment and therefore a compelling case for change has not been made.

Question 2: Can you provide any evidence that supports or would contradict our assessment against one or more of them?

Energy UK has concerns that increasing the cost of holding short term capacity by a combination of reduced discounts and a floating charge could impact on NBP liquidity which could have a greater impact on all three headings below that any marginal improvement that may be theoretically achieved.

Consumer bill impacts: we consider this to be neutral; it is not relevant to argue NG investment will be affected by the charging regime

Security of supply: we agree that the changes may be neutral for storage. We are not convinced that transaction costs at cross border points will be lower they may be higher. The charges will be higher for short term capacity which is used for managing daily fluctuations and for marginal supplies so there could be a detrimental impact on security supply. This could apply to flows from Norway as well as from continental Europe.

Promoting competition: These proposals simply shift the same pot of revenue from one set of uses to another so it is difficult to see how competition will be affected. This would seem to imply that competition is currently suboptimal, but the recent CMA report noted the gas wholesale market is performing well[7]. It is also argued that charges will be more cost reflective (we agree this is generally a good thing for competition) but when it comes to revenue recovery and short run marginal costing it is difficult to define what costs are being reflected in the charges.

In addition we do not understand how shippers are expected to respond to locational signals for short term capacity users[8] the physical commodity cannot readily be transferred between entry points. Also the addition of the same floating charge at all points, except storage, reduces the difference in charges between points on a percentage basis.

Question 3: Do you think there are other duties or aims that we should assess these changes against? If so, what are your views on how our changes might affect them?

Compliance with EU law will be key once the TAR NC is finalised, we understand some issues are being left for resolution in comitology so the final TAR NC will not be known for some time. We would urge caution against any steps to finalise these proposals or proceed with implementation prior to then and consider that time should be spent considering the issues identified above including the interactions with the shorthaul review and other UNC charging modifications to avoid a piecemeal approach and to establish a more robustly justified proportionate response.

Energy UK would be happy to discuss these points further, in the first instance please contact Julie Cox, details below.

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[7] https://assets.digital.cabinet-office.gov.uk/media/54ff238040f0b6140700000c/Gas_wholesale_market.pdf
[8] Paragraph 4.23 of consultation document

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