centrica energy

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Alena Fielding
Gas Transmission
Ofgem, 9 Millbank,
London
SW1P 3GE

27th March 2015

RE: Ofgem Gas Transmission Charging Review: Assessment of Potential Impact

Dear Alena,

Thank you for the opportunity to respond to Ofgem's Gas Transmission Charging Review Impact Assessment. This is a non-confidential response, which represents the view of the Centrica group of companies, excluding Centrica Storage.

Centrica welcomes the work that Ofgem and the technical working group have undertaken in this review so far. However, whilst we share many of Ofgem's concerns with the current methodology, in particular the growing proportion of revenue collected through the NTS Entry Commodity Charge, we disagree with the proposals for the 'floating' capacity charge. In addition to questions over the mechanics of the proposed changes, we have concerns over the timing of this review, the impact of the changes on Users, and the relatively limited number of options considered. In order to overcome these concerns and design the most appropriate solution, we believe the best way forward would be for Ofgem to initiate a Significant Code Review. This would provide for a more thorough and holistic review of the options for change and allow for a timeline which fits better with the development of the EU Network Code on Tariffs.

Below we provide our detailed responses to the individual questions set out in the consultation. We hope you find these comments useful. Please do not hesitate to contact me (email: ricky.hill@centrica.com; Tel: 07789579169) should you have questions on any aspect of this response.

Yours sincerely,

Ricky Hill
Regulatory Manager
Centrica Energy

1. What are your views on our proposed changes?

Timing

Centrica is concerned that the Ofgem review is taking place alongside the development of the EU Code on the Harmonisation of Gas Transportation Tariffs and that Ofgem is likely to take a final decision on these proposals before the EU Code has been finalised [1]. There is therefore a clear risk that any changes approved by Ofgem may have to be revisited when the Code is finalised, causing unnecessary cost and disruption to the industry. Furthermore, given that the goal of the review no longer appears to be to inform DECC and Ofgem about the adequacy of the EU tariff code, we would welcome insight from Ofgem into the current rationale for the review. This deeper understanding would better enable us to assess the proposals against the current objectives.

Whilst we accept that aspects of Ofgem's proposals are 'in the spirit' of the current EU Code drafting, we note that many of the major themes are still very much up in the air, with a total of 16 issues still being debated. We believe that having to undo changes is a real possibility given that the EU Code is likely to be very prescriptive on the structure of gas transmission capacity and commodity charges. Indeed, Ofgem itself recognises that its proposals for Short Term Tariffs are unlikely to be compliant with the current drafting of the EU tariffs code.[2]

We believe that the differing timescales of this review and the development of the EU Network Code on Tariffs is a strong (but not the only) argument in favour of Ofgem initiating a Significant Code Review. This would enable the options for change to be considered alongside the development of the Code and would lead to a more robust and future-proof result.

Alternative options

We believe that the review of options to date has been too narrow, both in terms of the range of issues examined and the proposed solutions to the problem of the rising NTS Entry Commodity charge: as an example, we would prefer to see a more thorough review taking into account the implications on short-haul. The risk of not undertaking a more thorough review is that a range of other defects could remain unconsidered and that a reasonably fundamental change is introduced to deal with the rising Entry Commodity charge issue when potentially simpler alternatives exist. Other issues with the current charging methodology that are not covered by this review include tariff volatility (on both exit and entry), incremental capacity and the inherent complexity of the current arrangements. Furthermore, rather than introduce a 'floating' capacity charge, a potentially simpler solution to deal with the rising Entry Commodity would be to tweak the current arrangements by increasing the LMRCs used to derive the auction reserve prices and reduce the discounts for Short-Term capacity products. Centrica does not necessarily support such changes but they demonstrate that alternatives exist. We believe this to be a further argument for initiating a Significant Code Review such that these and other options can be properly considered.

1 We understand that getting agreement on the final version of the Code is unlikely before 2016.
2 The latest draft of TAR NC states that the short-term discount needs to apply to the total capacity charge. Ofgem's proposals would just apply to the auction price and would therefore not be compliant with the above definition.

Proposals

From a purely theoretical point of view, replacing the NTS commodity charge with the ‘floating’ capacity charge might seem attractive. However, we believe that certain ‘real life’ implications have not been fully considered in the review and that theoretical and academic benefits have taken precedence. We provide some specific comments below:

- The introduction of ‘floating’ charge is likely to act as a disincentive to booking Long-Term capacity as shippers would no longer have certainty over their annual liabilities. This could have the perverse effect of reducing the already low levels of long-term bookings and further weaken the investment signals to National Grid. This does not appear to have been considered and such an outcome would run counter to Ofgem’s goal of generating better transmission investment signals through the charging methodology.

- If Ofgem does precede with its ‘floating’ charge proposals, it should not be applied to existing contracts as this would have a significant financial impact on shippers by fundamentally changing the value of their capacity holdings. Many shippers have existing contracts for capacity for up to 17 years which they purchased on the basis of a known price for the duration of the contract. Such longer term capacity contracts were entered into in good faith, consistent with the “user commitment” principle. These proposals are likely to substantially increase the fixed costs of that capacity, regardless of whether these shippers chose to flow gas. This is unjust as Long-Term capacity holders have already been paying far more in additional commodity charges than they could reasonably have expected when they made their capacity commitments. Ofgem’s proposals would formalise this over-payment through the fixed ‘floating’ price and remove the option not to incur the cost by not flowing gas. We believe that this sets a dangerous precedent and is not proportionate to the claimed benefits of the proposals.

- More generally, one of Ofgem’s key arguments in favour of the ‘floating’ capacity charge appears to be the provision of better information from shippers to help forecast supply patterns and more efficient transmission investment (e.g. 4.33 in the consultation document). However, we do not believe that this is a valid reason for changing the charging methodology. If improved information is required from shippers, this should be provided more directly through an information provision requirement rather than an alteration to the charging methodology.

- Centrica agrees that it would beneficial to review the multipliers for Short-Term capacity, although we do not yet have a view of what they should be or whether change is necessarily required. We recognise that increasing the reserve prices from zero for certain Short-Term capacity products would help counteract the significant rises we are seeing in the NTS entry commodity charge. However, this alone should not be used as a pretext for reducing the discounts. Any decision to alter the multipliers should be based on arriving at an improved compromise between reflecting the short-term marginal costs in day-ahead and within-day capacity products and the longer-term products. The consideration of multipliers for Short-Term capacity products should be a strong focus of any upcoming industry group and any proposed change to the current multipliers needs to be fully justified.

- Notwithstanding our belief that a ‘floating’ capacity charge should not be introduced, we agree with Ofgem’s rationale that storage users should be exempt if these proposals are implemented. This would be consistent with storage Users’ current exemption from the NTS commodity charges.

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

No. The rationale for rejecting the alternative options is very one-sided and relies on the sole assertion that “all users are not facing the true cost of the network [under the alternative methodologies]”. None of the potential benefits from the alternative options appear to have been considered. E.g. potentially less disruption to the market, more proportionate on current Long-Term capacity holders etc.

3. Do you think we have identified the relevant quantitative impacts?
4. Do you think we have modelled the impacts appropriately?

Centrica accepts that impact assessment modelling of this kind is inherently difficult and assumptions need to be made. The work that Ofgem has commissioned from CEPA / TPA solutions is a good start in measuring the impacts. However, we believe that some of the assumptions / simplifications made in the modelling cast doubt over the output to the extent that Ofgem should not rely on it when making a final decision. We note some more detailed comments below.

- The simplifications in the model invalidate the forecast changes in the ratio between Long-Term and Short-Term bookings. This is because the potential for physical constraints within the network is not considered by the model. A key factor for a shipper when deciding whether to book Short-Term or Long-Term capacity is the perceived probability (and impact) of being constrained off. If this probability (and impact) is high (e.g. for a UKCS gas field development with no other economically viable gas landing options), the shipper is more likely to book Long-Term over Short-Term capacity and vice-versa. The fact that this consideration is absent from the model casts doubt over the accuracy of the results.

- A further issue is that the model is static in that it does not take into account new sources of supply over the period to 2025. This is a fairly unrealistic assumption given the period under review. Whilst we accept that forecasting of future supply sources is fairly subjective, a potential improvement to the modelling would be to run some different scenarios based on expect new gas fields and other sources.

- Ofgem has identified most of the quantitative impacts but, in some instances, we find it difficult to draw the same conclusions. For example, Ofgem concludes that the reduction in discounts for Short-Term capacity should help reduce overbooking which is one of its main concerns with the current arrangements. However, apart from when a premium of 120% is applied to Short-Term products (which is not Ofgem’s favoured option), the modelling shows that “the demand for short-term capacity is not responsive to price (capacity charge) changes”. In other words, taking the data at face value, the quantitative analysis does not suggest that Ofgem’s proposals will result in more efficient booking behaviours.

5. Do you think we have identified the relevant qualitative impacts?

There are a number of qualitative impacts have not been covered in the Impact Assessment.

- Consideration needs to be given to ASEPs which accommodate both storage Users and regular users (e.g. Easington ASEP). Under Ofgem’s proposals storage would be exempt from paying the ‘floating’ charge. Given that shippers may hold capacity at a specific ASEP that may be used for both storage and UKCS/Interconnector flows (e.g.

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if they hold a traditional S-Store contract for Rough capacity), capacity at these ASEPs will need to be split into storage and non-storage capacity. Experience at Bacton has proven this to be a complex and highly contentious exercise.

- The potentially negative impact on shippers' commercial contracts has not been considered. A common practice amongst shippers is to hold long-term Gas Supply Contracts with a duration of several years for the supply or receipt of gas. Long-Term capacity will typically be purchased for the duration of the contract both to ensure that the gas can be landed but also to help hedge the value of the contract. Applying the 'floating' charge to this capacity will represent an additional (potentially significant) fixed cost which will not have been taken into account when the contracts were signed, potentially making them uneconomic.

- The proposed changes appear to have been examined in isolation from other areas of the charging methodology. The gas transmission charging methodology is highly intricate and changes in one area can have knock-on effects in other areas. One example is the interaction of the proposed changes with the NTS Shorthaul tariff. Many shippers who flow gas over short distances opt for this tariff which provides a discount to the NTS commodity charges. The rationale for this discount is to act as a disincentive to inefficient investment (i.e. building a separate pipeline) and to use the NTS as an alternative. As these proposals would remove much (if not all) of the NTS commodity charge, the discount would be significantly reduced when opting for a Shorthaul tariff. This could ultimately result in shippers using the transmission network less efficiently and undermine current contractual arrangements which underpin the efficient use of the system. This would be an undesirable outcome from these proposals and run counter to Ofgem's intentions.

6. Do you have any further evidence of the potential impacts of our proposed changes not covered by our analysis?

No

7. Do you agree with our assessment of how our changes would align with our principal objective and statutory duties?
8. Can you provide any evidence that supports or would contradict our assessment against one or more of them?

Consumer bill impacts: We agree that this is likely to be neutral.

Security of supply: We agree that the changes are likely to be neutral for storage. At this stage it is difficult to arrive at a definitive view of the impact on cross-border flows as this will depend on the detail of how these proposals are implemented. On the one hand, higher charges for Short-Term capacity could act as a disincentive to landing gas in GB at times of stress. The proposed changes are also likely to increase the volatility of charges which could have a negative impact on security of supply. On the other hand, replacing a variable flow-based charge with a fixed charge may result in lower transaction costs for cross-border trade in gas that is transported with Long-Term capacity contracts.

Promoting competition: We believe that competition would be negatively impacted by applying these changes to current contracts to which Users cannot respond. For this reason we also believe they go against Ofgem's 'best regulatory practice' objective. In addition, we are unconvinced that the 'floating' capacity charge would increase the cost-reflectivity of charges and would therefore not promote competition in this respect.

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9. 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

We have not identified any.