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RWE Supply & Trading
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Dear Alena

Gas Transmission Charging Review: Part II – our assessment of potential impact January 2015

We welcome the opportunity to respond to this Consultation. The comments are provided on behalf of RWE Supply and Trading GmbH and RWE Generation UK plc.

The GTCR document sets out Ofgem's policy proposals, together with the reasons why they think that they would improve the current charging regime. However, Ofgem does not provide any objective justification for its concerns with the current entry charging regime, nor does it provide any quantitative evidence why commoditisation of part of National Grid's allowed revenue in necessarily inappropriate in an unconstrained network. Concerns related to the volatility of commodity charges could be managed without a full scale reform of the charging regime.

The current arrangements provide flexibility, with Users able to match their capacity requirements to their particular portfolio. They can choose to fix their long-term entry capacity costs to add certainty to the costs of major infrastructure investments or choose short-term in response to price differentials. Removing this optionality or increasing its cost will impact the liquidity in traded markets and adversely affect investment decisions which may impact security of supply.

We consider that the current prices are cost reflective and based upon the marginal costs of providing that capacity and that this allows shippers to make access decisions that lead to economically efficient outcomes. Artificially moving away from these principles will create market distortions. Changing the relative price of short and long-term capacity will have an impact on capacity booking behaviour. Ofgem's modelling ignores this and the desired behavioural change envisioned by Ofgem is difficult to determine. Charge stability and efficient network investment is best based on long-term bookings and signals. However, these proposals incentivise short-term procurement of capacity by introduce floating prices a year out and retaining discounted reserve prices. These two policy elements do not appear to be complementary.

In Ofgem's view, the combination of fully-floating capacity charges and less generous short-term discounts would improve the efficiency of network use and promote efficient investment by National Grid, as well as facilitate security of supply. As set out in our responses to the detailed consultation questions we do not agree and believe that these policy options may not be consistent with Ofgem's principal objective and statutory duties.

We offer the following comments on the questions raised in the document:

CHAPTER 2: Explanation of our proposed changes to the charging regime

Question 1: What are your views on our proposed changes?
The current methodology generates prices that are reflective both of the costs that have been incurred in making physical system capacity available and reflective of the marginal costs that would be incurred by capacity release relative to the prevailing system capacity and conforms to Paragraph 5 of Standard Special Condition A5 of NGG's Gas Transporter Licence. Adding a uniform floating charge to the locational entry prices to ensure National Grid recovers its allowed revenues will improve cost recovery rather than cost-reflectivity. The locational signal may be diluted or distorted where a relatively high floating element is added to a low LRMC.

If cost recovery is the overriding policy objective, there are a number of different methodologies that could be used to give the desired level of cost recovery and that may be less disruptive to the operation of the downstream market. In our view, commoditisation of these costs remainsa valid option in an unconstrained network.

Ofgem assert that the combination of fully-floating capacity charges and less generous short-term discounts would improve the efficiency of network use and promote efficient investment by National Grid, as well as facilitate security of supply. Again, we fail to follow the logic here. Moving to a fully floating price is likely to weaken incentives to book longer than one year ahead given uncertainty about the payable price more than one year ahead. Ofgem's own modelling confirms that short-term bookings will continue to be important under a wide range of scenarios where daily capacity is offered at a discount. Within-day, day ahead and interruptible bookings are of limited value to National Grid with regards to investment decisions. The introduction of PARCAs effectively provides the mechanism to provide investment signals to national grid.

The response of shippers' bookings to the proposed change in relative costs between short and long-term capacity will also drive volatility in the payable price as the floating element to be recovered will vary each year.

The introduction of a floating charge will increase the costs of holding capacity when flows are uncertain is unlikely to lead to an increase in bookings. So, although transaction costs as represented by the Commodity charge may be lower under these proposals this benefit is only realised where capacity is held ahead of flowing. Capacity holding costs will be higher under these proposals. It is not clear to us that capacity will be acquired in advance to 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 are not convinced by Ofgem's assertions about the current arrangements encouraging over-booking. At a granularity of a quarter, long-term bookings winter quarter will based on peak requirements and the level of gas delivered on any day will, in part, be driven by the severity of the weather. Some users have had to book consecutive quarters to secure incremental capacity. Holders of this capacity pay whether or not they flow against it so they will be making a contribution to National Grid's costs.

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

Ofgem has explained that indexing entry capacity prices does not address all of its concerns and we agree that this approach should not be pursued. However, the rationale for rejecting a dual regime (i.e.TAR NC implementation at IPs only) has not been fully explained. Implementation of the CAM code will only be at IPs, which requires splitting existing capacity to accommodate different capacity regimes. A dual tariff approach at IPs would be simpler to deliver and it is not obvious that this would add significant additional complexity. Arguably, the proposed differential treatment of storage will require a de facto dual regime at Easington where there is both storage and non-storage capacity that will be each be exposed to different GB charging arrangements. A fuller consideration of limiting the implementation of Tariff NC to IPs only is required.

CHAPTER 3: Impact assessment of these proposals

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

Ofgem's policy proposals are to introduce fully-floating capacity charges for long-term capacity products and changing the charging arrangements for short-term capacity products. Given these, the objective to provide evidence of the potential quantitative impact on the level of entry transmission charges and distributional impact on network users is appropriate. However, there has been no attempt to model and quantify the adverse impacts arising from its concerns with the current arrangements.

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

While we welcome the attempt to model the complex interactions and outcomes from the policy options, as Ofgem itself notes "*the modelling necessarily includes a number of simplifications to make the* *analysis manageable. Consequently, the effects should be read as indicative, rather than specific*"[1]. We concur with this view. In particular, Ofgem has produced analysis of aggregate cost recovery and average level of entry charges under the policy options and assumed capacity booking and utilisation behaviour. However, should shipper booking behaviour change materially following changes in the relative prices of short and long-term capacity, then this will invalidate the model output.

While average charges are important, it is the distributional impact on individual shippers that will be a concern. Ofgem has correctly identified the main parameters that will determine the impact faced by individual Users. However, in many cases they will not be able to react and mitigate the adverse impacts, for example, those that purchased long-term capacity holdings to trigger incremental capacity release consistent with the IECR methodology, may face additional costs. Users that purchased long-term capacity under the current capacity arrangements to mitigate the impact of future charging volatility will be faced with a floating capacity charge.

Question 3: Do you think we have identified the relevant qualitative impacts?
Ofgem has identified the impact on cross-border trade. We agree that transaction costs, including transmission entry charges, can affect the arbitrage opportunities, and increasingly influence cross-border trade. However, it is not obvious that these proposals will necessarily help. While commodity charges (transaction costs) will be lower, Ofgem assumes that traders will already hold capacity and treat it as a sunk cost. We are not convinced that this will happen as capacity holding costs will increase under Ofgem's proposals, when compared to the existing position where capacity is offered at up to 100% discount.

Question 4: Do you have any further evidence of the potential impacts of our proposed changes not covered by our analysis?
The RIIO T1 framework has introduced uncertainty and incentive mechanisms, which allows the baseline allowances to flex. Ofgem has shown in this consultation that entry auction revenues have remained relatively stable against rising allowed revenues. There is a linkage between revenue predictability and charging predictability and stability and we are concerned these policy proposals will exacerbate the volatility and unpredictability of network charges. The impact of charging volatility on shippers and suppliers can be managed through the current capacity arrangements where they can fix their prices for a number of years into the future – this risk management option will be removed under these proposals.

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?
We do not agree that a strong case has been presented for why the changes align with the principal objective under the Gas Act 1986 to protect the interests of existing and future gas consumers. The benefits for consumers that Ofgem expect from their changes would be dynamic: potentially avoiding future bill increases by promoting the efficiency of National Grid's network operation; and ensuring that GB security of supply, including cross-border trade in gas, is not hindered by network charge. As set out below, our view is that these benefits will not emerge.

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

Consumer bill impact
The impact will be neutral, as the proposals will not change the revenue to be collected merely the basis upon which it is collected. We do not agree that reducing short-term capacity discounts would help

[1] Gas transmission charging review: Part II - our assessment of potential impact p 23

promote efficiency in planning, operating and maintaining the network and therefore there will not be downward pressure on costs.

Security of supply
On balance, the impact may be negative. Unwillingness to commit to long-term an unknown (floating) price may mean some projects are unable to go ahead.

Flows through IUK have been shown already to respond efficiently to price signals. As such, no change to the charging regime is required to address flow efficiency; in fact making changes where they are not needed in this way may compromise existing flow efficiency. Ofgem's view that lower GB commodity rates will promote additional flows is predicated on the assumption that parties will already hold the capacity rights. We do not think that this is likely, so the proposed change may increase the short-term marginal cost of trading with a consequent reduction in cross-border flows.

Promoting competition
At best these proposals have a neutral impact on competition. We do not agree that cost-reflectivity is improved, particularly with regards to short-term capacity. Previously, 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.

The impact of charging volatility and uncertainty on existing and new entrant shippers can be managed through the current capacity arrangements where they can fix their prices for a number of years into the future. This risk management option will be removed by the introduction of fully floating prices.

Best regulatory practice
We do not think that these proposals are consistent with best regulatory practice and will have the effect of increasing regulatory risk in the market. For existing long-term capacity holders, the introduction of a fully floating charge would amount to a retrospective change to the contractual basis that capacity was acquired.

Compliance with European law
We will not comment on this until the Tariff NC has been finalised. However, we are aware that these proposals are not consistent with the current drafting in a number of areas, including the treatment of legacy bookings and application of the discount.

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?
When the GTCR was launched in July 2013 with a call for evidence Ofgem believed that a review was due because of on-going significant structural changes to the GB gas market since and because emerging EU legislation to harmonise transmission tariffs (Tariff NC) might lead to significant changes to the GB regime in the next few years. The Tariff NC is not yet finalised and the details of the final Code are far from certain. There are also a number of initiatives being considered in the GTCMF, including shorthaul that will be influenced by the final Tariff NC. In our view, Ofgem should delay moving forward with its GTCR until Tariff NC has been finalised and to permit further consideration of the impacts of its proposals.

If you require any additional information or wish to discuss any aspects further, please do not hesitate to contact me.

Yours sincerely

By email so unsigned

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