

Alena Fielding
Gas Transmission
Office of Gas and Electricity Markets
9 Millbank
London
SW1P 3GE

Ritchard Hewitt
Gas Commercial Strategy Manager

ritchard.hewitt@nationalgrid.com

Direct tel +44 (0)1926 655861

Mobile +44 (0)7733 001817

www.nationalgrid.com

27 March 2015

Dear Alena

RE: GAS TRANSMISSION CHARGING REVIEW – OFGEM ASSESSMENT OF POTENTIAL IMPACT

This response is provided on behalf of National Grid Gas plc (NGG) in its role as owner and operator of the Gas Transmission System in Great Britain. NGG has worked with Ofgem, their consultants (Cambridge Economic Policy Associates (CEPA) and TPA Solutions) and stakeholders over the last 9 months as part of the GTCR Technical Working Group to facilitate the assessment of the current Gas Transmission Entry Capacity charging regime.

We agree that this review is timely and warranted in order to ensure that the transportation charging arrangements continue to remain fit for purpose given the changing nature of gas supply and demand within GB and the pending introduction of the EU Tariff Network Code.

We support both of Ofgem's policy proposals on the basis that we believe that:-

- a) Fully Floating capacity charges are aligned with EU Tariff Framework Guidelines,
- b) Reconsidering the current level of short term reserve price discounts has the potential to improve locational signals for efficient use of the system and encourage shippers to provide earlier indications of expected use of the system,
- c) Combining the proposed method of applying the Fully Floating charges through an adjustment to the capacity charge, based on bookings, together with a reconsideration of short term price discounts, may deliver a more fair-minded way of recovering historic network costs going forward. In addition, development and implementation of a combination of the two policy proposals could:-
 - i. reduce the unpredictability associated with TO Commodity charges,
 - ii. improve locational pricing signals, and
 - iii. improve network investment, maintenance and operational decision making.

We also agree that the ratio of short term to long term reserve prices needs further assessment and industry discussion to identify the optimum relationship.

Other aspects to consider as part of development of any solution include a possible locational element to the floating charges and whether to address emerging exit capacity charging issues in a similar timeframe.

We have provided further details on these matters in our response to the consultation questions within Annex 1 of this letter.

We look forward to working with Ofgem and stakeholders to further develop these policy proposals.

If you wish to discuss any of our response please contact Dennis Rachwal (dennis.rachwal@nationalgrid.com) (01926 644235).

Yours sincerely

A handwritten signature in purple ink, appearing to read 'Ritchard Hewitt', enclosed within a large, loopy oval shape.

Ritchard Hewitt
Gas Commercial Strategy Manager

Annex 1

Our detailed responses to the consultation questions raised:

The consultation and hence our responses below are primarily related to the impacts of the policy proposals on the NTS Entry Capacity Charging regime.

We would also like to draw attention to recent trends that have begun to arise in NTS Exit Capacity Charging that are similar to those which have, at least in part, triggered this review of Entry charges (i.e. increase in TO Exit Commodity charges from 14% to 36% of TO Exit allowed revenue in 3 years and the increasing take up of zero priced Off-peak Capacity). In Annex 2 we provide further detail on this issue and how it might warrant further consideration alongside GTCR.

CHAPTER 1 GTCR background to our findings

We agree with Ofgem's rationale, findings and the conclusions highlighted from their literature review as set out in this chapter.

CHAPTER 2 Explanation of proposed changes

CHAPTER 2: Question 1: What are your views on our proposed changes?

In principle we support a combination of the two policy proposals. We consider that in combination they offer the potential to efficiently address the concerns raised in this review through reducing TO Entry Commodity Charges and preparing for GB compliance with the impending EU Tariff Network Code. We agree that these proposals should be further developed with industry to meet both the objectives of this review and the relevant objectives set out in the NTS Licence.

Short term discounted reserve prices / promotion of long term capacity bookings.

We believe that the recent and future forecasted steady decline in demand for natural gas, together with the change in patterns of supply, has led to reduced demand and competition for NTS Entry Capacity. The perceived low risk of short term congestion has in turn led to shippers moving away from booking, and being committed to, long term capacity products. Instead shippers are being attracted to the discounted short term reserve prices of the "daily" Capacity products. Reducing the short term discounts would, in our opinion, go some way towards arresting or reversing this trend. The degree of reversal would of course be aligned to the relationship between long and short term prices. Short term products also have inherent features compared to long term products in that, even though obligated capacity is generally available to purchase every day, actual purchases can be profiled to the daily requirement. As such, in a world where congestion is rare, and the price for long term and short term products were to be the same, there would still be commercial benefits in delaying capacity purchases until closer to the time of use. Therefore the prevailing regime incentivises shippers to maximise short term bookings through these two factors.

During 2009 NGG worked with industry to develop charging proposals (GCM19¹) and these aimed to address the perceived issues regarding the zero reserve prices within the daily Entry Capacity regime. The GCM19 proposals were later rejected by Ofgem. Since 2010 there has been an on-going trend in the reduction of long term bookings. We agree that consumer interests may now be better served by short term pricing that, in addition to short run marginal costs, also has appropriate recovery of historic capacity costs.

We believe that the key to addressing the current decline in long term capacity purchases is to address the incentives which may be a factor in encouraging shippers to move to the short term market. As such we would support further industry assessment and consideration of the appropriate ratio of short term and long term capacity prices.

Floating capacity price revenue adjustment

The network is available to all shippers everyday but with the prevailing commodity based under-recovery mechanism, it is only those shippers that flow on that day that bear the full costs associated to the under-recovery. We therefore consider floating charges would potentially introduce a more fair minded approach to allocation of historic system costs. We agree that the policy proposals would see such costs borne by those signalling their desire to have the network available for use.

Whilst supporting Ofgem's proposals for floating capacity charges we consider that they would be enhanced by having a locational element. A detrimental effect of having a uniform TO Commodity charge is that it flattens locational signals. Likewise, replacing the TO Commodity charge with a uniform floating capacity charge would also flatten locational signals. Therefore we believe adding a locational element to the proposed floating capacity charge would lead to an improvement in locational signals and better cost reflectivity.

EU Compliance and cross border flows

The EU Framework Guidelines on Rules Regarding Harmonized Tariff Structures for Gas² (upon which the prevailing draft EU Tariff Network Code³ is based) requires commodity charges at Interconnection Points (IPs) to reflect just those costs that are related to energy flow where the associated capacity prices are "floating". This is in contrast to the current GB regime where entry capacity prices are fixed "pay as bid" and any under-recovery is collected by the TO Entry Commodity charge. It is clear that the fully floating capacity charge element in Ofgem's proposals would move the GB regime closer to the Framework Guidelines requirement.

The Framework Guidelines and prevailing EU Tariff Network Code requires short term auction reserve prices to have a multiplier of between 0 and 1.5 whereas the GB

¹ <https://www.ofgem.gov.uk/publications-and-updates/decision-letter-modification-proposal-national-transmission-system-nts-gcm-19-%E2%80%98removal-nts-daily-entry-capacity-reserve-price-discounts%E2%80%99>

² [http://www.acer.europa.eu/Official_documents/Acts_of_the_Agency/Framework_Guidelines/Framework%20Guidelines/Framework%20Guidelines%20on%20Harmonised%20Gas%20Transmission%20Tariff%20Structures.p](http://www.acer.europa.eu/Official_documents/Acts_of_the_Agency/Framework_Guidelines/Framework%20Guidelines/Framework%20Guidelines%20on%20Harmonised%20Gas%20Transmission%20Tariff%20Structures.pdf)

³

http://www.entsog.eu/public/uploads/files/publications/Tariffs/2014/TAR0450_141226_TAR%20NC_Final.pdf

regime has discounts of 100% within day (i.e. multiplier = 0) and 33% for day ahead (i.e. multiplier = 0.67). Thus the Ofgem proposal to reduce the current GB discounts would be compatible with the prevailing draft EU Tariff Code.

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

We agree with the reasons for rejecting the alternatives for the following reasons.

Payable price

To adjust the payable price for inflation would not, in our opinion, materially change the revenue recovery position or address concerns that have been raised regarding high TO Commodity charges. RPI adjustments would only materially change the revenues for capacity holdings if applied over long time periods, and, with reducing levels of QSEC⁴ (i.e. the longest term Entry bookings) being booked, the impact on TO Commodity charges would be small and therefore would not effectively address the concerns identified in the review.

Dual regime

Whilst we agree that aspects of the EU Tariff Network Code could be implemented at IPs only, we consider it would be more prudent to implement a single methodology for all points. We believe that striving for a single regime would avoid undue complexity and associated administrative costs being introduced to the GB charging regime. A single regime would also help guard against the potential for the introduction of undue preference or cross subsidy that could arise in a dual regime.

CHAPTER 3: Impact assessment of these proposals

General commentary on the modelling section:

We agree that there is no need to further model the dual regime scenario due to the small effect that Interconnector flows are likely to have on the wider GB regime and the level of uncertainty around the final version of the EU Tariff Network Code. The four scenarios shown, based on the base case of the current methodology and fully floating (each with two sets of discounts applied), provide a reasonable foundation to show the potential impact of different charging changes and of a range of discount levels.

The behavioural aspect centres on one key assumption within the analysis, that the booking levels remain the same in the analysis. Therefore, in our opinion, the point to consider is whether these bookings will move from Long Term to Short Term or vice versa under the options modelled. The analysis concludes that there would be no change in behaviour if the short term reserve price remains less than the long term price and there is spare capacity on the NTS. We therefore believe the analysis does not adequately show how the revised regime would encourage a change to the trend in shipper booking behaviour – an outcome that we believe is fundamental to addressing developments in the transmission business. The option of long term capacity having a lower cost than short term should be explored

⁴ NGG has recently reported the 2015 QSEC bid details to Ofgem. The auction closed on the second day of bidding.

more in future analysis to show the effect on TO Capacity and Commodity prices arising from booking behaviour change.

CHAPTER 3: Question 1: Do you think we have identified the relevant quantitative impacts?

The quantitative impacts highlighted focus on the average TO Entry Capacity / TO Entry Commodity prices, revenue provided by User Groups and revenue by product type (Long Term / Short Term). We suggest that due to EU considerations, during the later stages of the development of the proposals, there would be benefit in consideration of the interactions with SO Entry Commodity charging.

Throughout the analysis presented the levels of capacity bookings remain unchanged and the variances are driven by:

- a. The proportion of capacity booked in the long and short term; and
- b. The levels of flow made against shippers' capacity holdings.

We agree that showing the impacts on average capacity prices is useful in terms of providing a steer on the potential impact of the change, especially for those shippers with a geographically diverse portfolio of capacity bookings. Whilst Appendix 6 of the consultation document provides some analysis of 6 key entry points this may not be sufficient for those shippers with other regional or locational specific entry capacity.

The impact on TO Commodity charges, with it being a universal charge for all, irrespective of location, should be a helpful indicator for shippers to determine impacts for them based on their flows. The scenarios detailing different proportions of flows relative to the capacity holdings is also a useful indicator as there will be those with higher ratios than others.

Showing the proportions of revenue by User Group and by product type is useful and we believe is relevant as it shows the makeup of the revenue distribution across shipper types and between long and short term bookings.

CHAPTER 3: Question 2: Do you think we have modelled the impacts appropriately?

We believe that the modelling is clear in showing the general trends from the various options considered. The assumptions, logic and outcomes are reasonable.

There are some areas we consider are worth highlighting concerning the modelling of the impacts:

- We feel that the scenario where the long term price is less than the short term price would benefit from more detailed analysis in order to show the impact on TO Entry charges. This is the only scenario considered in the analysis that results in a change in shipper behaviour in moving between short and long term capacity. We believe that the GTCR proposals should encourage shippers to change booking behaviours with incentives for bookings to be closer to flows and to encourage more timely bookings. We therefore believe there would be benefit from modelling greater detail in terms of the impacts.

- Capacity bookings at “Storage” points have been included in the modelling and then excluded in the final policy solution. It may be helpful to carry out further analysis to demonstrate the effect that arises through exclusion of storage from having the float applied. Whilst we believe that the impact on charges of this may be minor it is worth acknowledging the impact on the resulting Entry charges.
- The supply matching merit order is an input to the current Transportation Model and is currently subject to UNC modification proposals (UNC Mod 517/517A/517B). The proposed changes could alter the calculated prices used in the analysis, and the revenue contributions from customers since they adjust the locational distribution for some of the capacity charges.
- The existing pricing discounts are taken from the prices used within the “Monthly” (MSEC) capacity auctions, and the discounts proposed / modelled within Ofgem’s document are from the “Quarterly” (QSEC) auctions. Once changes to discounts/multipliers are defined in more detail it may be helpful to further highlight the impacts on all relevant prices.
- Detailed development of change proposals may lead to additional or altered impacts and these may warrant further modelling in due course.

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

Cross Border Trades

We agree with Ofgem that the impacts of these proposals on cross border flows will be dependent on the ratio of capacity bookings to flows for shippers. Where the bookings are more closely aligned with flows this should drive down the net transaction cost for cross-border gas trades when taking into account the total of capacity and commodity charges.

In the development of the European Tariff Code Framework Guidelines one of the core goals has been to facilitate cross border trading and so promote the free flow of gas across the EU. We believe that Ofgem’s proposals are currently well aligned to help achieve this goal of the Framework Guidelines.

Network investment and efficient provision and operation of the network

We believe the proposals have the potential to deliver more useful and timely data for long term capacity signals and so better inform network investment decisions. Improved capacity booking data (both in timeliness and as indication of flow intentions) may also better inform maintenance planning decisions and efficient scheduling of flows. This will be dependent on having shipper incentives to book longer term rather than shorter term capacity. If this incentive is not sufficiently incorporated then the impact could have opposite effect with a risk of further flight from long term to short term capacity booking.

Predictability of charges

We believe that the effect of both elements of Ofgem's proposals would be to increase the proportion of allowed revenue recovered from Entry Capacity charges. As a result this will reduce the variability associated with the TO Commodity charge. Where there is a material increase in long term capacity bookings there will be a positive effect on charge predictability in that the quantity of over or under recovery would therefore be known earlier in the charge setting cycle. The change from TO Commodity to Capacity charges for revenue adjustment may, in the early stages of implementation, reduce charge predictability because of the unknown initial behavioural changes. This however should reduce as experience of the new regime builds.

Entry locations with storage and non-storage entry points

We believe there are impacts which the industry and Ofgem should consider in relation to how to exclude capacity for Storage from the "float" for ASEPs that contain both storage and non-storage system Entry points.

EU Compliance

The impacts of the proposals will need to be reassessed to ensure compliance with the finalised EU Tariff Network Code. For example there may be one or more alternatives available for achieving the principles of the GTCR policy proposal on floating charges as these might be levied in a different way perhaps such as via a locational element.

In addition we consider that it is likely that further changes could be required as a result of the EU Tariff Code being finalised, specifically with regards to how the TO and SO revenues interact.

Wider impacts / interactions

- Legacy capacity

We recognise that some shippers have raised the issue of treatment of legacy Capacity holdings and we agree that this should be considered as part of the development and implementation of any proposals.

- Potential broader implications

As part of the development process for implementing any policy direction, there may be impacts on other processes or charging arrangements. Whilst these may not be in the scope of GTCR, these will need to be reviewed as part of any solution, for example User Commitment or IT system impacts. We appreciate however that it may be prudent to delay considerations of such impacts until such time as the EU Tariff Code is finalised and any consequent adjustments to GTCR policy decisions are made.

CHAPTER 3: Question 4: Do you have any further evidence of the potential impacts of our proposed changes not covered by our analysis?

We believe there is the potential for unintended consequences from some combinations of floating prices and short term capacity multipliers which could lead to an increased incentive to procure short term capacity rather than long term capacity and hence exacerbate the issues identified in the proposals. For example, if short term pricing was low compared to longer term prices, the application of floating charges could result in more of a flight to short term capacity booking. In a regime with excess capacity and an absence of a long term booking incentive shippers may continue the trend to book shorter term and reduce their total amount of exposure to floating charges. We believe this is a factor to consider in discussing the appropriate ratio of short term to long term prices.

CHAPTER 4: Assessment against our objectives

CHAPTER 4: Question 1: Do you agree with our assessment of how our changes would align with our principal objective and statutory duties? and Question 2: Can you provide any evidence that supports or would contradict our assessment against one or more of them?

NGG broadly agrees with Ofgem's assessment in terms of its principal objective and statutory duties although we would advocate placing more emphasis on encouraging timely and accurate capacity bookings in order to promote more efficient system availability.

Consumer impacts

By improving the quality and timeliness of the data used in the operation and management of investment, maintenance and operation of the NTS, NGG agrees that the proposals could deliver some beneficial effect on consumer bills. This may also be achieved through efficiencies gained by more cost reflective locational charges resulting in further improvements in the ability of shippers to compete effectively to deliver the lowest cost supplies to end consumers.

Security of supply

We agree that the proposals would not have a material effect on security of supply although reducing the TO Commodity cost barriers for capacity holders may have some positive effect in encouraging flows onto the system.

Promoting competition

We agree with Ofgem's analysis of the effect on competition particularly if locational signals are preserved in both long and short term Capacity charges.

Compliance with European law

As stated above it will be important to review these proposals in the context of the finalised EU Tariff Code.

Timely decisions

We believe that there needs to be timely decisions for making changes to the charging regime, particularly where implementation is to be aligned with EU regulation. In particular the development of any proposals and associated implementation timescales need to consider the implications for business processes and systems, changes to the UNC and related methodologies and statements and potentially the Gas Act Licences.

Network investment and network operation

We believe that one of the key benefits from the proposals will come from delivering better quality and more timely information provision which in turn will lead to better and more timely network investment decisions. There is also potential for better maintenance and operational decisions.

Network Investment

We believe that the provision of accurate and timely capacity requirements from our customers is fundamental to the efficient release of incremental capacity and the substitution methodology. It underpins the investment decision process and this increasingly encompasses non-incremental investments.

Whilst the change to fully-floating prices may lead to capacity bookings being closer to actual flows it is the changes to short term capacity prices relative to the long term that is more likely to result in both more accurate and timely information provision. Our views on the effect on over and under investment risk and on non-incremental investment are as follows:-

- **Over-investment risk**

We agree with Ofgem that the over-investment risk is mitigated by the introduction of the PARCA arrangements for the release of incremental capacity whilst also noting also our obligations to develop an efficient and economic network and our incentives under RIIO-T1. As a result of our wider licence obligations we will not necessarily build physical capability to meet capacity signals under all supply and demand scenarios. For the purposes of identifying investment needs we will, in addition to capacity bookings, take into account baseline levels of capacity, anticipated utilisation rates and the pipeline security standard in our network analysis.

- **Under-investment risk**

While investment linked to incremental capacity can only be triggered by entering into a PARCA, investment decisions linked to PARCAs will have to be taken in the light of long term capacity bookings. The current low level of long term entry capacity bookings may lead to capacity investment signals being missed either as a result of unsold capacity being booked longer term or capacity substitution being initiated leading to the demand for capacity at an ASEP being greater than was anticipated at that ASEP. While such a scenario can be rectified in the longer term, this may lead to periods of constraints and high capacity charges in shorter term auctions. It could also lead to sub-optimal investment decisions if investment is made in multiple tranches rather than through a single capacity signal. Increased long term bookings that are reflective of expected flows will contribute to a more robust basis for managing under-investment risk.

- Non-incremental investment

Non-incremental capacity drivers for investment, such as asset health issues and legislative change, may outweigh incremental capacity related investment in future. We have recently engaged with the industry regarding investment proposals relating to the impact of the Industrial Emissions Directive (IED) on our compressor fleet. IED currently impacts on a proportion of our compressor fleet but future IED related or other legislative changes are anticipated to cover a great proportion of the compressor fleet. A greater degree of confidence in the longer term capacity bookings would better facilitate developing options to address these future changes.

Network Operations

The effect of the proposals on the current level of capacity bookings could be material. The prevailing arrangements mean that a greater amount of historic cost recovery is targeted at those parties who flow on the day. Recovering these costs from all capacity holders, irrespective of whether the capacity is utilised on the day, could lead to greater incentives for shippers to seek to manage their capacity bookings to be more closely aligned to their anticipated flows. If shipper capacity bookings tend to move away from within day to day ahead or earlier this will provide more opportunity to use the information for efficient network operation. Therefore it is the combination of Ofgem's two proposed changes that can lead to these positive impacts.

The degree of benefit from improved capacity booking information is difficult to gauge at this time. However, there is potential to assist with efficient maintenance planning and short term scheduling of the system. To deliver the scheduling benefits the capacity booking information would need to be received at the same time or earlier than current indicators of flow (shipper nominations and flow notifications) i.e. ahead of the gas day.

Developments in transportation business

We agree with Ofgem's assessment that their proposals address the recent developments in the transportation business. Since the present charging regime was designed there has been a gradual and sustained reduction in gas demand and this has inevitably reduced competition for entry capacity as supply outstrips demand. There has also been a large increase in gas importation and more variation in the patterns of supply from more diverse sources, and again this has resulted in surplus entry capacity. The amount of capacity has led to some shippers making extensive use of the opportunity to purchase capacity at short term discounted, and often zero prices. This has led to a lack of useful capacity booking information for decisions on network investment, maintenance and operations, and under-recovery of historic capacity costs that has resulted in higher TO Commodity charges. The proposals go some way to rebalance this effect. The extent of any rebalance is dependent on how far the final proposals reduce/remove the financial incentives to either:

- 1) delay capacity bookings and/or
- 2) reduce over booking.

CHAPTER 4: 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?

Over the next 15 to 20 years the GB and European energy industry is likely to go through a great deal of change as we move to a more sustainable energy future. We consider it is important therefore to develop these proposals in a direction which is aligned with delivering a charging regime that is able to respond to the needs of

consumers and encourages the efficient and economic transition to the new energy regime, whilst maintaining security of supply.

Annex 2

Considerations to review NTS Exit Capacity charging arrangements

NGG notes Ofgem's intention for the GTCR to focus on Entry Capacity charges. However, as stated earlier, we consider there are similar issues emerging within the NTS Exit charging arrangements as those which have triggered this review (i.e. an increasing proportion of recovery of historic capacity costs through TO Commodity charges) and we note that the EU Tariff Framework Guidelines apply to both Entry and Exit.

On TO Exit charging there has been an increase in the TO Exit Commodity charge from 14% to 36% of the TO Exit allowed revenue since 2012. We believe that this rise in TO Exit Commodity charges provides an early indicator that there is a trend for some shipper bookings to move away from long term "firm" Exit Capacity bookings and into short-term discounted products. The incentives for such a shift in behaviours may differ in detail but the zero reserve priced "Off-peak" Capacity product and a low perceived risk of constraints and associated scale back of capacity rights is common to the drivers in the Entry regime.

We would therefore welcome the opportunity to discuss reviewing aspects of NTS Exit charging at the same time or on a similar timescale to GTCR. This would, if delivered as part of a single step change in the capacity charging methodology coinciding with the EU Tariff code, reduce the complexity associated with multiple separate changes and implementation programmes.

