

Interested parties and
stakeholders

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Dear colleagues,

RIIO-T1: Our decision on National Grid Gas Transmission's application under the RIIO-T1 Compressor Emissions uncertainty mechanism

The purpose of this letter is to set out our final decision on National Grid Gas Transmission (NGGT)'s price control re-opener application, made under paragraph 5E.6 of Special Condition 5E of NGGT's Gas Transporter licence, for an additional £41m to comply with emissions legislation.

In July 2015 we consulted on our assessment of NGGT'S application and welcomed the views of interested parties in relation to any of the issues set out in the document. The consultation closed on 1 September 2015 and we received three responses in total, all of which have been published on our website.¹

Our final decision

Having carefully considered all of the responses and taking account of our powers and duties, and in accordance with paragraph 5E.13 of Special Condition 5E of NGGT's Gas Transporter licence, we have decided to reject NGGT's application for an additional £41m. The reasons for our decision and a summary of the consultation responses are set out below.

Background

In its RIIO-T1 business plan NGGT forecast spending of £813.5m to ensure compliance with two environmental directives: the IPPCD² (Integrated Pollution Prevention and Control Directive) and the IED (the Industrial Emissions Directive)³. When we made our decision on the RIIO-T1 price control⁴ for NGGT there was uncertainty about some of the requirements under new legislation, (the IED), which were expected to be implemented in GB after Ofgem concluded its RIIO-T1 Final Proposals. Hence, we introduced an uncertainty mechanism, in order to provide more time for NGGT to develop its approach

¹ <https://www.ofgem.gov.uk/publications-and-updates/consultation-draft-decision-nggts-application-under-riio-t1-compressor-emissions-uncertainty-mechanism>

² <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2008:024:0008:0029:EN:PDF>

³ <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:334:0017:0119:en:PDF>

⁴ This was the first price control to be conducted under our new RIIO model (Revenue = Incentives + Innovation + Outputs). Through RIIO-T1, we set the price control framework to apply to electricity and gas transmission companies from 1 April 2013 to 31 March 2021.

in response to this new legislation. This would ensure that funding was matched to the needs case and improved deliverability by better alignment of funding with actual project expenditure.

Our RIIO-T1 Final Proposals provided baseline funding of £142.7m for specific projects, whereas some projects were rejected. We also acknowledged that NGGT would still be required to undertake works for both IPPCD Phase 4 and the remaining sites considered within the IED (second phase) and to optimise its portfolio of options. We also proposed a baseline of £9m for emissions abatement optioneering to enable NGGT to develop an integrated and cost-effective plan to comply with the requirements of IPPCD Phase 4 and IED Phase 2.

Additionally, we allowed £269.3m for the IPPCD Phase 4 and IED Phase 2 projects, to recognise NGGT's obligation to incur expenditure to comply with this legislation. The level of this baseline was based on the information at the time, where capex projects were forecast. If NGGT's expenditure set out in its plan was different to this amount, we reserved the right to adjust the baselines up or down. We expected that NGGT's integrated plan would include opex solutions as well as capex projects. As a result, we divided the baseline between capex (75 per cent or £202.0m) and opex (25 per cent or £67.3m). We also described the further work that we expected NGGT to undertake in order to justify this additional provisional expenditure of £269.3m and we set out the timetable for the re-opener submissions in its gas transporter licence.

In our consultation we acknowledged the work that NGGT had undertaken to develop its revised plan. In particular we welcomed the stakeholder engagement and recognised that NGGT had considered the views of network users as part of the process. We believe that this is an important part of the development of any business plan that we have to evaluate and had improved the quality of the submission overall, compared to the RIIO-T1 business plan.

We also recognised the efforts made by NGGT to consider some alternatives to investment more actively, especially the use of the available exemptions and derogations which may allow continued use of some compressors and which represents a good outcome for consumers.

However, we did not believe that NGGT had fulfilled the specific requirements we set out for the re-opener submission. In particular it had not included a comprehensive cost benefit analysis, clearly identifying all assumptions made, of its revised plan to justify the additional expenditure. We think a clear demonstration of the costs and benefits of each option is an important part of the stakeholder engagement, to help stakeholders in forming their views. Where NGGT had discounted particular solutions, such as the use of catalysts to treat exhaust stacks, it was unable to quantify the impacts.

Summary of consultation responses

The responses did not provide a clear consensus of views about our draft decision. One respondent (a shipper) agreed with our position not to approve the additional funding requested, arguing that as we (and our consultants) had identified that the submission failed to satisfy the criteria set out in Final Proposals and it was unclear whether more or less revenue was required, it was not sensible to make any changes at this stage. It also thought that the purpose of the re-opener was to assess whether the approach proposed by National Grid was directionally sensible and not to sign-off or rubber-stamp the detailed plans and submissions.

NGGT disagreed with our view and was concerned that not approving the additional funding was effectively delaying any decision until 2018 which introduced regulatory uncertainty, in particular given that it would need to commence work on a number of the

sites ahead of that date. NGGT also argued that stakeholders had been fully supportive of the process and satisfied with the level of information provided for the recommended option to make an informed decision at each site. It also further explored whether there was additional evidence it could provide to support its recommendations. Additionally, in its response NGGT did provide some additional detail about its proposals and clarifications where it considered that the consultants had incorrectly interpreted some details in part of its plan.

Another respondent (a trade body) agreed with many of the points made by the consultants but was broadly supportive of NGGT's plans. Nevertheless they would have liked to have seen future network flexibility requirements included as an input to the planning for forecast compressor use. They were also concerned that by not agreeing to the additional funding asked for, we were setting aside the views of stakeholders who had reacted positively to NGGT's proposals during the stakeholder engagement.

Our reasons for the decision

We remain of the view that, whilst NGGT submitted proposals based on the outcomes of stakeholder engagement as part of this process:

- The omission from the stakeholder engagement process of underlying assumptions, additional options, and more detailed cost and benefit data for the range of options considered, limited stakeholders' ability to engage effectively;
- It did not fully take on board the comments from all stakeholders; and
- Although we specifically required cost benefit analysis as part of this process, NGGT has stated it only costed the final solution to take forwards based on the feedback from stakeholders. We expected NGGT to include the costs and benefits of all considered options as part of its submission.

We do not think that the decision can be interpreted as not taking stakeholders' views of NGGT's proposals into account. Since the costs and benefits of all considered options were not included, NGGT had not presented a full picture, thus not allowing stakeholders to form a considered view with all relevant information being available.

Additionally, some of the funding NGGT had identified is linked to anticipated future legislation (Medium Combustion Plant Directive) and whilst this may be a prudent action on some sites, NGGT had not quantified the benefit of the suggested approach and shown how this approach compares to the alternatives.

Whilst there are specific sites where there is more clarity on the need for NGGT to intervene, the cost benefits of the proposals have not been fully explored and we consider the allowance already given in RIIO-T1 allows NGGT to complete the current profile of works up to at least 2018.

Based on the above we conclude that whilst NGGT has undertaken some good work, developed better detail, and engaged with stakeholders, the submitted plan does not meet the criteria we set out in our Final Proposals and hence the justification for the expenditure is not adequate. We therefore reject the request for additional funding at this stage.

Next steps

While we have rejected the request at this point, it remains open to NGGT to re-submit it with further evidence at the next RIIO-T1 re-opener window in 2018.

As highlighted in the consultation, this particular re-opener is symmetric and Ofgem can also propose changes to the allowed revenues in this area. Taking into account the conclusions of our consultants and the potential for further reductions in cost which they identified, we will want to consider whether there is a case to revise downwards the provisional allowance of £269.3m made in RIIO-T1 Final Proposals.

NGGT has raised concerns that this leaves it in an uncertain position facing the risk that Ofgem will be judging elements of its request on an ex post basis.

Ofgem recognises that there are difficulties with ex post assessment as the company faces the risk that costs will be disallowed but has no opportunity to outperform in the way that it can with an ex ante allowance. This can distort incentives and lead to companies taking an unduly cautious approach in how they manage projects. For this reason Ofgem generally prefers to set ex ante allowances where it can⁵. Given this we accept that we need to provide some clarity about the approach we will adopt in the future in judging the appropriate allowance, recognising that NGGT may need to make investment decisions ahead of the next re-opener window.

Consistent with the approach we have taken now, as part of any re-opener in 2018:

- We will require NGGT to demonstrate that they have considered the future network requirements and a full range of options;
- These should be supported by comprehensive cost benefit assessment (CBA) as required in RIIO-T1 final proposals;
- CBAs should include clear and robust assumptions; and
- Any decision we make during the 2018 reopener will consider the information (eg current or any known future changes to legislation and/or policy) available to NGGT at the time of committing to any investment and will not rely on hindsight.

We will work with NGGT over the coming months to provide any additional clarification necessary on our approach.

Yours faithfully,



Paul Branston
Associate Partner, Gas Networks

⁵ https://www.ofgem.gov.uk/sites/default/files/docs/2010/10/decision-doc_0.pdf