

To gas shippers, gas storage operators, National Grid Gas Transmission, gas consumers and their representatives and other interested parties

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## **Open Letter: European Union Network Code on harmonised transmission tariff structures for gas (TAR NC) and the industry<sup>1</sup> Gas Transmission Charging Review (GCR)**

This letter sets out our<sup>2</sup> updated thinking on the implications for the Great Britain (GB) gas transmission charging regime in light of the Gas Transmission Charging Review (GTCR), for which we published a policy view in November 2015,<sup>3</sup> and the European Network Code on gas transmission tariffs (TAR NC) which we anticipate will apply from April 2017. As anticipated in the GTCR, we recognise that aspects of the GB gas transmission charging regime will require changes in order to comply with TAR NC.<sup>4</sup> Furthermore, given requests for further clarity on the scope of changes and options available, we believe it would be helpful to set out our thinking at this stage.

This is required by TAR:

- Introduction of 'floating payable prices'<sup>5</sup> for National Transmission System (NTS) entry and exit capacity at interconnector points (IPs).
- The cessation of commodity charges for the purpose of managing under- and over-recovery of transmission services revenue at IPs.
- Setting the price of interruptible capacity (including off peak capacity) at IPs to reflect the probability of interruption.
- Setting the discount to be applied to transmission tariffs at entry points from and exit points to storage facilities to avoid double charging for transmission to and from storage facilities. (We look to industry participants to work out the exact discount structure taking due regard of the impact of the changes to the tariff regime and to provide due justification for the level of discount proposed.)

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<sup>1</sup> Joint Office NTS Charging Methodology Forum (NTS CMF) Gas Charging Review

<sup>2</sup> The terms "the Authority", "we", "us" and "our" are used interchangeably in this letter. The Authority is the gas and electricity markets authority. Ofgem is the office of the Authority.

<sup>3</sup> <https://www.ofgem.gov.uk/publications-and-updates/gas-transmission-charging-review-confirmation-policy-view-and-next-steps>

<sup>4</sup> We anticipate TAR NC to enter into force before April 2017 but with the most significant changes required by 31 May 2019. The version of the TAR NC voted on at comitology may be found at the following location: <http://www.gasgovernance.co.uk/sites/default/files/EU%20Tariff%20Code%20-%20final%20clean.pdf>

<sup>5</sup> The TAR NC defines 'floating payable price' as where the reserve price is subject to adjustments.

In addition, and subject to the Uniform Network Code (UNC) consultation process, our current view is that we would support:

- Introduction of 'floating payable prices' for NTS entry and exit capacity. This will enable National Grid Gas Transmission (NGGT) to adjust the price paid by a user in the capacity auction or allocation process to recover its allowed revenue. This applies to long-term and short-term capacity products at all entry and exit points (both IPs and non-IPs) to recover 'transmission services revenue'.<sup>6</sup>
- The cessation of commodity charges for the purpose of managing under- and over-recovery of transmission services revenue at all points.
- Setting the price of interruptible capacity (including off peak capacity) at all entry and exit points to reflect the probability of interruption.
- Reduction of reserve price discounts for short-term capacity products at all NTS entry and exit points. (We look to the GCR to work out the exact discount structure taking due regard of the impact of the changes to the tariff regime and to provide due justification for any discounts proposed.)

As a consequence, subject to the UNC consultation process, our current view is that we would not approve the implementation of a 'dual regime' for the recovery of transmission services revenue of 'floating payable prices' at IPs only, combined with a 'capacity charge + variable commodity charge' regime at non-IP points.

## **Background**

### *Gas Transmission Charging Review (GTCR)*

We launched the GTCR in June 2013. We considered a review was required because of significant and ongoing changes to the patterns of gas flows in the NTS, as well as the emerging TAR NC. On 15 November 2015, we published the confirmation of our policy view and recommendations marking the end of the GTCR and a transition to preparing for the TAR NC finalisation/development and implementation.

Through GTCR, we proposed two key changes to gas transmission entry charging policy:

1. Introducing 'floating' capacity charges for entry capacity at all entry points (non-IPs, with the exception of storage users, and IPs); and
2. Reducing the reserve price discounts for short-term entry capacity products at all points (subject to the final text of the TAR NC<sup>7</sup>).

We did not anticipate a change to the methodology used to calculate the long-term capacity reserve prices but that there would be a separate identifiable floating element of capacity entry charges. We proposed that storage users would not pay the floating element of capacity charges, preserving the existing arrangements whereby they do not pay the commodity charge.

However, we did not commit to proceeding immediately to the implementation of floating capacity charges at all entry points for two reasons:

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<sup>6</sup> The TAR NC defines the 'transmission services revenue' as the part of the allowed or target revenue which is recovered by transmission tariffs. This may be considered to be broadly equivalent to the NTS Transportation Owner (TO) revenue as defined in National Grid Gas Plc (NTS) Gas Transporter Licence Special Conditions.

<sup>7</sup> The prevailing version of the TAR NC in November 2015 would not allow discounting of capacity charges at IPs. The final version allows discounts for daily and for within-day standard capacity products in duly justified cases.

1. The uncertainty at the time of the final provisions of the TAR NC relating to capacity charges and hence what changes GB might need to make to comply.
2. The potential to implement a 'dual regime'. This would comprise floating charges at IPs only (as mandated by the TAR NC) combined with the existing 'fixed capacity + variable commodity' regime at non-IP entry points.

We invited NGGT and industry to follow up on our GTCR policy view by forming work streams to take forward TAR NC. This is now being conducted by the GCR in its broad review of the GB Charging framework, including the charging methodology.<sup>8</sup>

#### TAR NC

The TAR NC received a positive vote from the Member States of European Commission Gas Committee on 30 September 2016. We anticipate that it will enter into force by April 2017. We now know the final provisions of the TAR NC and have greater clarity on what changes GB will need to make to its gas transmission charging regime to comply with these provisions.

We believe our GTCR policy view on entry charges is consistent with the final TAR NC. Specifically, our views are:

- That the TAR NC, while not prohibiting fixed price entry capacity charges, supports the use of floating capacity charges.
- That the TAR NC allows, as an exception, commodity charges to be levied to manage under- and over-recovery of transmission services revenue; however, we do not believe there is sufficient justification for such an exception. We provide detailed reasons for our view in the annex to this letter.
- That TAR NC adds to our GTCR view and now encompasses exit points as well as entry points.
- That we do not support a 'dual regime' for the recovery of transmission services revenue of 'floating payable price' at IPs only, combined with a 'capacity charge + variable commodity charge' regime at non-IP points. However, we do acknowledge that the TAR NC provides scope to apply differential treatment between IPs and non-IPs in other aspects of policy. We expect the GCR to consider our views with regard to the 'dual regime' and also any other policy aspects, and to provide justification for any differences in approach between IPs and non-IPs in any Uniform Network Code modification proposals.

We will continue to work with NGGT and the industry over the coming months in the GCR to implement the TAR NC, taking account of our policy views, to deliver arrangements which enable the provision of a safe, secure, high quality transmission system that delivers value for money to existing and future consumers.



**Chris Brown**  
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#### Annex 1

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<sup>8</sup> The terms of reference of the GCR may be found at the following location:  
<http://www.gasgovernance.co.uk/sites/default/files/Gas%20Charging%20Review%20ToR%20NTSCMF%20V1.0.pdf>

## Annex 1

### Reasons for policy update.

We believe that our GTCR policy view which we published in November 2015,<sup>3</sup> is consistent with the final TAR NC. We explained the reasons for our policy view in the November 2015 document and in our previous publications.<sup>9,10</sup>

This annex explains why we believe GTCR is consistent with TAR NC insofar as NTS entry points are concerned and also why we think the extension of our GTCR view to exit points is consistent with and supported by TAR NC.

### Application of floating capacity charges at all entry and exit points

The current GB gas transmission charging regime incorporates floating/variable capacity charges at all exit points.<sup>11</sup> We continue to be of the view, expressed in our GTCR policy, that floating capacity charges should be introduced at all entry points. TAR NC requires floating capacity charges to be applied at all IP points and we believe that applying floating capacity charges at all entry and exit points is consistent with TAR NC.

Article 6(3) applies to all entry and exit points and states the following:

*"The same reference price methodology shall be applied to all entry and exit points in a given entry-exit system ..."*

We believe that Article 6(3) supports applying floating capacity charges at all entry and exit points.

Article 17(2) of TAR NC applies to all entry and exit points and states the following:

*"Where and to the extent that the transmission system operator functions under a price cap regime or applies a fixed payable price approach ... no revenue reconciliation shall occur and all risks related to under- or over-recovery shall be covered exclusively by the risk premium ..."*

We interpret this as meaning we would no longer be able to apply revenue reconciliation if we continued to allow fixed capacity entry charges at IPs. We believe that such a restriction on revenue reconciliation is not compatible with the fundamental principles underlying our allowed revenue, RIIO price control regime.

Article 24 of TAR NC applies to IPs only, but it provides a useful definition of fixed payable price and floating payable price that clearly indicates that it is a capacity product.

While Article 17(2) does not explicitly prohibit the application of a fixed price approach at non-IPs, we believe that applying floating capacity charges at all entry and exit points is more appropriate and fully consistent with TAR NC.

Accordingly, our policy preference is that the GB adopt a tariff regime that incorporates the floating payable price approach at all entry and exit points. This would replace the current 'fixed capacity charge' on entry, the current 'variable charge' on exit and the 'variable commodity charge element' on entry and exit, which is levied only on shippers who flow gas onto the system to manage under- and over-recovery of TO revenue. This will enable NGGT to adjust the price paid by a user in the capacity auction or allocation process to

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<sup>9</sup> <https://www.ofgem.gov.uk/publications-and-updates/gas-transmission-charging-review-our-policy-position-future-charging-arrangements>

<sup>10</sup> <https://www.ofgem.gov.uk/publications-and-updates/gas-transmission-charging-review-gtcr-part-ii-our-assessment-potential-impacts>

<sup>11</sup> The current exit capacity charges vary or 'float' with the aim of recovering 50% of the TO allowed revenue; however, forecast under-recovery of TO revenue is collected by levying a TO exit commodity charge.

recover its allowed revenue. Our policy preference applies to long-term and short-term capacity products at all entry and exit points (both IPs and non-IPs) to recover 'transmission services revenue'.

### **Cessation of commodity entry and exit charges for the recovery of 'transmission services revenue'**

We believe that our approach, expressed in our GTCR policy, to move towards a more cost reflective tariff regime in GB is supported by the TAR NC. Recital (3) of the TAR NC states that "*in order to achieve and ensure a reasonable level of cost reflectivity and predictability in such a system, transmission tariffs need to be based on a reference price methodology using specific cost drivers*". The TAR NC in Definitions (18) states that "*'cost driver' means a key determinant of the transmission system operator's activity which is correlated to the costs of that transmission system operator, such as distance or technical capacity*". Article 4(1)(b) also refers to "*forecasted capacity*" as a cost driver.

We believe that TAR NC provides for a very specific interpretation of cost reflectivity to be used for gas transmission tariffs.

Article (4)(1)(b) says "*the costs of such service are related to the investment in and operation of the infrastructure which is part of the regulated asset base for the provision of transmission services.*"

We interpret this as meaning that the transmission tariffs should reflect costs incurred, by NGGT, including all historical network costs.<sup>12</sup>

Article 4(3) of TAR NC specifies that "*transmission services revenue shall be recovered by capacity-based transmission tariffs*". It allows "*as an exception*", and "*subject to*" our approval "*a part of the transmission services revenue may be recovered ... by ... commodity-based transmission tariffs*". Other than for commodity-based tariffs which are "*levied for the purpose of covering the costs mainly driven by the quantity of the gas flow*" these commodity-based transmission tariffs may be "*levied for the purpose of managing revenue under- and over-recovery*" but not at IPs and only after our "*... assessment of its cost-reflectivity and its impact on cross-subsidisation between interconnection points and points other than interconnection points*".

We do not believe that the current use of non-locational commodity charges, levied for the purposes of managing under- and over-recovery of transmission services revenue should be continued as we do not consider them to be cost reflective in the context of TAR NC as their derivation does not incorporate the required cost drivers.

We expressed the view in our GTCR policy, that commodity entry charges, levied only on shippers who flow gas onto the network for the purposes of managing under- and over-recovery of transmission services revenue, do not contribute to the improvement of cost reflectivity of charges. We believe this is consistent with TAR NC. We believe that the same also applies to commodity exit charges levied only on shippers who flow gas off the network.

NTS Exit Capacity Charges are administered rates designed to recover 50% Transportation Owner (TO) allowed revenue. However, like NTS Entry Capacity Charges, in recent years there have been significant shortfalls in the allowed revenue collected through exit capacity charges. Consequently, there has been an increasing reliance of NGGT on the non-locational TO exit commodity charge to recover its allowed revenue.

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<sup>12</sup> In some instances, network charges are comprised of separate forward-looking incremental charges (which are used to signal the value or cost that users place on the system) and residual cost-recovery charges (that ensure allowed revenues are recovered). In these cases, cost reflectivity is more relevant to the assessment of the forward-looking incremental charges, while it is still important that the residual cost recovery charges do not distort the cost-reflective signals

Accordingly, we would consider the continued use of commodity charges, for the purpose of managing revenue under- and over-recovery in any modification proposal submitted to us for the implementation of the TAR NC to not be compliant.

### **Due justification of the level of discounts applicable to short-term capacity products**

The changes to the GB tariff regime that would result from our policy preferences, in particular that of prohibiting commodity-based charges for managing under- and over-recovery of transmission services revenue, will likely result in entry and exit capacity charges increasing. The application of the prevailing discounts at entry and exit points would therefore result in higher absolute benefits compared to those currently received by network users. We believe there is a need to review and correct this.

Notwithstanding the above considerations, we continue to be of the view, expressed in our GTCR policy, that the level of discounts applied to short-term entry capacity products should be reduced. Similarly, we believe that the level of discounts for short-term exit capacity products should also be reduced.

Article 13(1)b of TAR NC applies to IPs only and for the level of multipliers<sup>13</sup> for daily capacity products states the following:

*"In duly justified cases, the level of the respective multipliers may be less than 1, but higher than 0".*

The TAR NC has no specific requirement on the application of discounts at non IPs.

We believe that the "duly-justified" approach that is applied to discounts at IPs is equally applicable at other entry and exit points. We continue to be concerned that the current level of short-term discounts means that a large proportion of users may avoid contributing sufficiently to the recovery of network costs. We consider that reducing short-term discounts would improve the cost-reflectivity of charges and contribute more to the NGGT's allowed revenue.

### **Interruptible Capacity**

We believe the reasons for supporting the reduction of the level of discounts applied to short-term capacity products apply equally well to the reduction of discounts applied to interruptible and off peak capacity.

Article 16 of TAR NC applies to IPs only and specifies that the price of interruptible capacity at all entry and exit points shall reflect the probability of interruption.

We believe that this approach is equally applicable at other entry and exit points and that this approach is more compliant with the Gas Regulation (Regulation (EC) No 715/2009).<sup>14</sup> Article 14(1)b of the Gas Regulation states the following:

*"Transmission system operators shall: ...*

*(b) provide both firm and interruptible third-party access services. The price of interruptible capacity shall reflect the probability of interruption ... "*

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<sup>13</sup> A multiplier less than one has the same impact as a discount.

<sup>14</sup> <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:211:0036:0054:en:PDF>

## **Due justification of the level of discounts applicable to transmission and non – transmission tariffs<sup>15</sup> at storage facilities**

The changes to the GB tariff regime that would result from our policy preferences, in particular prohibiting commodity-based charges for managing under- and over-recovery of transmission services revenue, together with the requirements of the TAR NC, means that it will not be possible to preserve the existing arrangements to avoid double charging for transmission to and from storage facilities.

Recital (4) of the TAR NC states that *“In order to avoid double charging for transmission to and from storage facilities, this Regulation should set a minimum discount acknowledging the general contribution to system flexibility and security of supply of such infrastructure.”*

Article 9(1) of TAR NC specifies that *“A discount of at least 50% shall be applied to capacity-based transmission tariffs at entry points from and exit points to storage facilities”*

We believe that the above considerations require a review of the level of discounts applied at storage. Subject to the 50% minimum applied to capacity-based transmission tariffs, we believe that the “duly-justified” approach that is applied to discounts at IPs is equally applicable at storage facilities. We look to industry participants to work out the exact discount structure taking due regard of the impact of the changes to the tariff regime and to provide due justification for the level of discount proposed.

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<sup>15</sup> The TAR NC defines the ‘non-transmission tariffs’ as the charges payable by network users for the regulated services other than transmission services and other than services regulated by Regulation (EU) No 312/2014 that are provided by the transmission system operator. The ‘non-transmission services revenue’ may be considered to be broadly equivalent to the NTS System Operator (SO) revenue as defined in National Grid Gas Plc (NTS) Gas Transporter Licence Special Conditions.