To interested parties.

Direct Dial: 020 7901 7025
Email: daniel.newby@ofgem.gov.uk

Date: 4 August 2017

Decision on the Fleetwood entry point in gas transmission

National Grid Gas Transmission (NGGT) is the owner of the high pressure gas National Transmission System (NTS) in Great Britain. To ensure value for money for consumers, we regulate NGGT through periodic price control reviews that limit its revenues and specify outputs that NGGT must deliver. Within NGGT's licence it specifies how much entry capacity it must make available at different entry points to market participants.

NGGT has an obligation to provide 650 GWh/day of entry capacity at Fleetwood. This capacity was created when a storage developer purchased it in 2006. We funded NGGT £277.5 million[1] in the current price control (RIIO-T1)[2] and the previous price control (TPCR4) rollover year[3] to build a number of pipelines and other network infrastructure upgrades to meet this capacity obligation. However, the project did not proceed and the capacity remains largely unsold. NGGT does not expect to spend any of the allowances we provided during this price control.

Following a review and consultation[4], we have decided to remove £277.5 million from NGGT's price control allowances to ensure consumers do not pay for work which has not been carried out. We have also decided to reduce its capacity obligation to 350 GWh/day because:

- We consider that there is a low risk to consumers of incurring costs to provide this level of capacity (NGGT does not expect to have to invest in the network to provide that level of capacity). This protects consumers from investment cost risks that could materialise if a higher level of capacity were purchased at auction.

- It still allows a potential new storage project to proceed in its planned timelines without needing to acquire capacity through a different and more lengthy process.

We will issue a consultation shortly to amend NGGT's licence and reduce the capacity obligation. The reduction to NGGT's price control allowances will take place as part of the 2018 annual iteration process; we will will consult on the consequential changes to the Price Control Financial Model (PCFM) in due course.

The remainder of this letter sets out more detail and background on our decision.

[1] This is in 2009-10 prices for consistency with RIIO final proposals documents https://www.ofgem.gov.uk/ofgem-publications/53599/1riiot1fpoverviewdec12.pdf .
[2] RIIO-T1 is the price control for transmission network companies (including NGGT) which runs from 2013 to 2021.
[3] TPCR4 is the price control for transmission network companies which ran from 2007 to 2012. This price control was rolled over for one year (2012-13).
[4] https://www.ofgem.gov.uk/system/files/docs/2017/03/fleetwood_consultation_letter.pdf

Background

In 2006, Canatxx Shipping Limited (Canatxx), a developer, bid for 650 GWh/day entry capacity for a new gas storage facility planned at Preesall, Lancashire. At the time, NGGT was not obliged to offer entry capacity at Fleetwood and a new entry point had to be created in order to meet Canatxx's requirement.

Users requiring new entry capacity must commit to funding a share of the deemed cost of providing the capacity. This is known as the user commitment. User commitment helps promote efficient investment in the NTS by ensuring that shippers, developers and investors in new projects take account of the deemed costs of network investment in their investment decisions. This also limits the exposure of consumers to the costs of providing the capacity.

Canatxx's bid passed the user commitment threshold and in 2007 we approved the release of entry capacity of 650 GWh/day and included it in NGGT's licence. Canatxx acquired the right to use the entire capacity at Fleetwood for the duration of its user commitment. After that, the capacity would have been available to all users at auction.

Canatxx failed to receive planning permission for its storage site and defaulted on its credit obligations when they became due in 2009. Subsequently, Canatxx lost its right to entry capacity at Fleetwood as well as its obligations to make future payments for capacity.

NGGT had carried out preparatory work so that it could meet its capacity obligation, but halted work when it became clear that Canatxx had defaulted on its payment obligation. No physical infrastructure has been built and no expenditure by NGGT has been reported since 2010.

The capacity obligation at Fleetwood remains in NGGT's licence. Another developer, Halite Energy Group (Halite), is now planning a smaller development at the same location and in March 2016 a shipper bought 350 GWh/day at Fleetwood for £252,000 for use in one quarter in 2025. No other purchases have been made at Fleetwood to date.

We announced our intention to review the RIIO price control treatment of the funding and capacity obligation for Fleetwood entry point in November 2016[5]. We have reviewed this now as NGGT started to receive price control revenues for Fleetwood in April 2017.

In March 2017, we consulted on removing NGGT's funding of £277.5 million and removing the full capacity obligation (650 GWh/day) at Fleetwood.

NGGT funding

Consultation

In our consultation, we proposed to remove the £277.5 million funding now. We considered that this option would best protect the interests of consumers by making sure that they do not fund investment that has not taken place. It also meant that consumers would not have to wait until the end of the price control for the allowances to be returned.

Responses to funding issue

Most of the respondents agreed or did not comment on our proposal on the price control funding for Fleetwood.

[5] https://www.ofgem.gov.uk/system/files/docs/2016/11/review_into_the_treatment_of_national_grid_gas_transmissions_capacity_obligation_at_fleetwood_under_the_riio-t1_price_controls.pdf

The Office of Gas and Electricity Markets
9 Millbank London SW1P 3GE **Tel** 020 7901 7000 **Fax** 020 7901 7066 **www.ofgem.gov.uk**

Centrica agreed with our proposal, stating that there is no evidence of funding being needed during RIIO-T1. Energy UK also agreed, saying that this is consistent with known expenditure, delivers a fair outcome and benefits to customers in a timely manner, which is consistent with protecting the interests of consumers. RWE also agreed, stating it will benefit consumers earlier than the other option of reconciling the allowance at the end of the price control. Storengy also agreed with us, stating there is no point in passing costs to consumers for work that will not take place.

Halite objected to our proposal as it sees this as negatively affecting regulatory certainty. However, it indicated it would not object to reconciling allowances at the end of this price control. NGGT did not object to our proposal but said it preferred to reconcile allowances at the end of RIIO-T1 due to the small risk of it incurring investment.

Decision

We have decided to remove the £277.5 million funding as NGGT does not expect to carry out work during RIIO-T1 in order to provide the obligated capacity. Our decision ensures that NGGT is not funded for work that has not been carried out.

We have decided to remove the funding now as this ensures consumers will benefit from the revenue reduction sooner than if we wait until the end of RIIO-T1. The adjustment will be implemented through the 2018 annual iteration process and NGGT's revenues will be reduced from April 2019.

Capacity obligation

Consultation

In our consultation, we proposed to remove all of NGGT's capacity obligation at the Fleetwood entry point. We considered that this option would best protect the interests of consumers. It ensured that consumers were not faced with all of the network investment costs associated with providing 650 GWh/day capacity. It also ensured that future users would need to commit to paying their share of the cost of providing capacity.

Responses to the capacity issue

Respondents were divided on whether the capacity obligation should be removed or not. Four of the ten respondents supported removing all of the capacity as this option best protects consumers from incurring costs related to reinforcing the network.

Five respondents supported leaving the capacity obligation in place. A number of these raised concerns that if we remove the capacity this may have have a longer term impact on regulatory confidence.

Halite said that removing the capacity would cause significant regulatory uncertainty with no benefit to consumers relating to the capacity obligation removal. It stated that removing the capacity could pose a wider risk to investment decisions across the whole network. It also pointed to our 2011 Income Adjusting Event decision[6] where we stated "seeking to make licence modifications to remove NGGT's obligation to provide capacity at Fleetwood without the consent of the parties concerned could be considered to be undermining the regulatory regime, which would ultimately be to the detriment of consumers". It said that this could have a further impact on the cost of capital, which increases costs for consumers in the longer term.

Barrow Green Gas stated that the Fleetwood capacity is relied on by industry and should remain in place. It noted that there has been a commitment to purchase capacity (the one

[6] https://www.ofgem.gov.uk/sites/default/files/docs/2011/05/110506-fleetwood-iae-decision-final.pdf

quarter that was sold for 2025) and that opportunities to connect at Fleetwood had been actively pursued since we concluded in our 2011 Income Adjusting Event decision that the capacity should remain.

Halite also stated that we did not consider a number of other factors, such as security of supply or greenhouse gas emissions, within our consultation and impact assessment. It said that "should Ofgem proceed with its preferred option, the future decision of Preesall will inevitably be reconsidered. Any such outcome would clearly be detrimental to the consumer interest". It also said that its project supports the reduction of greenhouse gas emissions by accelerating the replacement of coal and provides support to deal with intermittent renewable energy generation.

UK Onshore Oil and Gas were against removing the capacity obligation due to the impact this would have on shale gas development. It stated that some developers would be unlikely to be able to book capacity through the Planning and Advanced Reservation of Capacity Agreement (PARCA)[7] process as they would not be able to provide sufficient user commitment.

Decision (Capacity)

We have decided to reduce NGGT's capacity obligation to 350 GWh/day. We have received new information from respondents, which led us to change our position. We may decide to remove all of the capacity at a future review (either of Fleetwood or a wider review of capacity baselines) if we consider this to be in consumers' interests.

In carrying out our functions we are required to act in accordance with our principal objective and duties as set out in the Gas Act 1986. In this case, this has led us to consider the following two key principles: cost reflectivity and proportionality.

Cost reflectivity: We consider that users of the NTS should bear a reasonable proportion of any network investment costs that may be incurred in relation to their activities. This limits the exposure of consumers to network investment costs and helps promote efficient investment in the NTS. We previously thought that by leaving the full amount of capacity in place, consumers would be exposed to the risk of investment costs of up to £135 million. We are now aware that NGGT expects to be able to provide 350 GWh/day capacity without the need to invest in the network, ie without consumers providing any funding.

Proportionality: We also need to weigh up the benefits of our decision for consumers in avoiding risks of funding investment against the negative impact this may have on other parties. If our decision is considered to have a disproportionately negative impact on users then this may harm regulatory confidence, which will ultimately have a negative effect on consumers. We previously thought that if we removed the Fleetwood capacity, the negative impact on users would be reasonable because users would still be able to obtain capacity through the PARCA process. However, following consideration of the specific circumstances of Halite's project it is clear that removing the capacity at this time could have a significant impact on its project. The risk of increased costs and project delays may affect whether the Preesall project goes ahead or not.

Our decision to reduce capacity to 350 GWh/day ensures that Halite's project planning is not disproportionately affected. It also reduces the risk to consumers of facing network investment costs to provide the capacity.

Therefore, we do not consider that our decision on the capacity (and funding) will have an impact on regulatory confidence. We also note that we have consistently made it clear that the capacity obligation could be subject to review, in particular we stated this in our RIIO

[7] PARCA is part of the Uniform Network Code. It allows NTS entry/exit capacity to be reserved for a user while it develops its project.

The Office of Gas and Electricity Markets
9 Millbank London SW1P 3GE **Tel** 020 7901 7000 **Fax** 020 7901 7066 **www.ofgem.gov.uk**
OFFICIAL

final proposals document and again in our November 2016 letter. We also note that at the time of making our Income Adjusting Event decision, we were required by the Gas Act 1986 to obtain the licensee's (NGGT) consent to amend licence conditions. This legislation has since been amended and we no longer need to get licencees consent to make licence changes. We have consulted with the licencee and taken its views into account.

We do not consider that our decision will have a negative impact on gas security of supply. Our decision should not prevent Halite's project from proceeding. However, even if no project connects at Fleetwood, the UK has a diverse and flexible range of options to provide secure gas supplies.

We note the issues shale gas developers have raised with regard to booking capacity through the PARCA process. However, Ofgem's principle objective is to protect the interests of consumers. We do not think it would be fair to consumers to leave the full capacity obligation in place as consumers would be faced with the risk of network investment costs. Our decision to leave some capacity in place ensures consumers are protected from network investment costs (NGGT expects to provide this level of capacity without reinforcing the network). It also means that capacity is available for all users (including shale gas developers) to have the opportunity to book the 350 GWh/day without needing to use the PARCA route. Moreover, we think the PARCA process provides an appropriate route for acquiring capacity above this level as it protects consumers from investment costs, but still allows developers to acquire capacity via substitution if there is no investment required.

We want it to be clear that we may review the Fleetwood capacity baseline again at a future date. This may include removing the capacity obligation in its entirety if this is in consumers' interests. For instance this may be necessary to ensure that consumers are not adversely affected by any future changes on the network that mean investment would be required to meet the capacity obligation. Alternatively, it may be necessary if capacity remains largely unsold, as we do not consider it appropriate to leave the risk of changes necessitating investment on consumers for an indefinite period if projects fail to progress. This could include being part of a wider review of capacity baselines.

Next steps

PCFM change

In order to remove the Fleetwood funding from NGGT, we need to adjust the PCFM. We will carry out a statutory consultation as part of the annual iteration process in 2018 to ensure that adjustments to NGGT's revenues begin to take effect from April 2019.

Licence change

NGGT's Gas Transporter licence (Special Condition 5F) requires it to provide 650GWh/day capacity at the Fleetwood entry point. In order to reduce this obligation we will need to amend this licence condition. We will carry out a statutory consultation on modifications to this condition of NGGT's licence later this year.

If you have any queries regarding this decision please contact Daniel Newby (daniel.newby@ofgem.gov.uk).

Yours faithfully,

Kersti Berge
Partner, RIIO Networks

The Office of Gas and Electricity Markets
9 Millbank London SW1P 3GE **Tel** 020 7901 7000 **Fax** 020 7901 7066 **www.ofgem.gov.uk**
OFFICIAL