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Modification proposal:	**Uniform Network Code (UNC) 636/A/B/C/D: Updating the parameters for the National Transmission System Optional Commodity Charge**		
Decision:	The Authority[1] has decided to reject this modification[2]		
Target audience:	UNC Panel, Parties to the UNC and other interested parties		
Date of publication:	31 July 2018	Implementation date:	n/a

Background

The 'Optional Commodity Charge' (OCC) tariff was introduced in 1998 with the intention of providing an option for shippers seeking short distance transportation of gas. The OCC aims to avoid inefficient bypass of the National Transmission System (NTS). It can be paid by NTS users as an alternative to standard Transmission Owner and System Operator commodity charges (Standard Commodity Charges).

The modification proposal

In October 2017, Vermilion Energy Ireland Ltd (Vermilion) raised UNC636, proposing an update to the parameters of the OCC formula.[3] Vermilion thinks that the charges, which have not been updated since the introduction of the OCC in 1998, are no longer representative of the costs of building by-pass pipelines. Vermillion also thinks that the current charges give rise to cross subsidisation from those unable to use the OCC (largely Distribution Network connected load) to those that can use this charge (NTS direct connects including interconnectors). Vermilion referred to estimates by National Grid Gas (NGG), according to which the 'cross subsidisation' is around £150m per annum.

UNC636 was considered by the UNC Modification Panel (the Panel)[4] at its meeting on 19 October 2017 and sent to workgroup for development. Subsequently, four alternate modification proposals were raised by industry and sent to the workgroup for development. The modification proposals vary as follows:

- UNC636: Proposes to replace the current formula, in line with NGG's 2015 proposal in its discussion document NTS GCD11 (Option 2).[5] It also proposes to replace the Maximum NTS Exit Point Offtake Rate in the current formula.

[1] References to the "Authority", "Ofgem", "we" and "our" are used interchangeably in this document. The Authority refers to GEMA, the Gas and Electricity Markets Authority. The Office of Gas and Electricity Markets (Ofgem) supports GEMA in its day to day work. This decision is made by or on behalf of GEMA.
[2] This document is notice of the reasons for this decision as required by section 38A of the Gas Act 1986.
[3] https://www.gasgovernance.co.uk/0636
[4] The UNC Panel is established and constituted from time to time pursuant to and in accordance with the UNC Modification Rules.
[5] https://www.nationalgrid.com/uk/gas/charging-and-methodologies/gas-charging-discussion-gcd-papers

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- UNC636A: Proposes to keep the current formula, but introduce a distance cap, set at 115km.
- UNC636B: Proposes to update the current formula by indexing to RPI and inserting a methodology into the UNC.
- UNC636C: Proposes the UNC636 change, but exempts all Interconnector Points from this change until an enduring solution is implemented that recognises the European Tariff Network Code requirements.
- UNC636D: Proposes to update the current charging formula by indexing to RPI, but exempts all Interconnection exit Points until an enduring solution is implemented that recognises the European Tariff Network Code requirements.

On 9 April 2018 the Joint Office received a request on behalf of Vermilion for a change in modification status to 'urgent' for UNC636. Following consideration, on 9 May 2018 we decided not to grant that request.[6]

The workgroup report was considered by the Panel at an extraordinary meeting on 23 May 2018 and sent out for industry consultation. The Panel then considered the Final Modification Report (FMR)[7] at its meeting on 21 June 2018.

UNC Panel recommendation

At the Panel meeting on 21 June 2018, the Panel did not recommend implementation of any of the modification proposals. The Panel considered that no clear majority view existed on the preference of whether any of the proposed modifications facilitates the Relevant Objectives better than the others and subsequently sent all proposals to us for a decision.[8]

Our request for evidence dated 29 June 2018

The FMR discussed the availability of information in respect of contracts and specific investment projects, both in terms of costs and potential building. The FMR noted the conclusion of the workgroup that considered such information would be confidential and therefore parties would be best to share details with Ofgem only.[9] On 29 June 2018, we invited interested parties to provide further information to that included in the FMR and in the industry's responses to the consultation on the FMR.[10] In particular, we requested:

- Detailed evidence of any impact of each of the 636 modification proposals on interested parties' businesses.

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[6] Ofgem, UNC0636 Updating the parameters for the NTS Optional Commodity Charge – request for urgency (9 May 2018): https://www.ofgem.gov.uk/system/files/docs/2018/05/636_urgency_letter_final_09052018_0.pdf
[7] UNC modification proposals, modification reports and representations can be viewed on the Joint Office of Gas Transporters website at www.gasgovernance.co.uk
[8] Page 109 of the FMR
[9] Page 36 of the FMR
[10] UNC636 'Updating the parameters for the NTS Optional Commodity Charge':
Request for evidence to inform our decision (29 June 2018):
https://www.ofgem.gov.uk/system/files/docs/2018/06/unc636_request_for_evidence.pdf

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- Information relating to any proposal for building a by-pass pipeline.
- Detailed evidence in respect of the distributional impacts of each of the 636 modification proposals.

Our invitation stated that we should receive any information by 13 July. Sixteen stakeholders responded. The respondents requested that the information submitted should be treated as confidential.

Six respondents provided detailed information and evidence, in all cases indicating that the potential impact of the proposals on their businesses would be negative. Seven respondents provided further information compared to that contained in the FMR; of these, six stated that the likely impact of the proposals on them would be negative. Two provided no new information compared to that contained in the FMR. One respondent was unable to provide evidence in the time available.

Our decision

We have considered the issues raised by UNC636 and its alternatives (hereafter referred to collectively as 'UNC636'). We have considered and taken into account the responses to the industry consultation, the FMR and the views of the Panel. We have also carefully considered and taken into account the responses to our request for evidence. We have however concluded, based on this information, that implementation of UNC636 will not better facilitate the achievement of the Relevant Charging Methodology Objectives of the UNC and is not consistent with our wider duties.[11]

Reasons for our decision

We consider the modification proposals will not facilitate better charging methodology relevant objectives (a), (b) and (c), and are not consistent with our statutory duties. We also consider the modification proposals will have a neutral impact on the other charging methodology relevant objectives.

(a) save in so far as paragraphs (aa) or (d) apply, that compliance with the charging methodology results in charges which reflect the costs incurred by the licensee in its transportation business

The workgroup noted that the adjustments to the OCC, under modification proposals UNC0636, 0636A and 0636C, would reduce the Standard Commodity Charges (all other things being equal) and improve its cost reflectivity. Moreover, the workgroup noted that adjustments to the OCC, under modification proposal UNC0636D, would ensure that the OCC formula is robust to the current cost environment and that charges to OCC and non-OCC users would be more reflective of current cost.

[11] As set out in Standard Special Condition A5 (5) of the Gas Transporters Licence

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Whilst we agree in principle that the OCC should be cost-reflective, it is unclear whether the envisaged benefits are likely to materialise. We also note the lack of sufficient evidence underpinning the proposals that has been provided as part of the FMR and that we highlighted in our urgency decision letter should be provided as part of the industry process. The envisaged benefits are, in part, based on the assumption that the proposed modifications would not affect gas flows. This disregards the potential impact on gas flows resulting from increased costs to OCC users. This potential benefit to non-OCC users also requires that any reduction in costs by those that are currently using the Standard Commodity Charge will be passed on. However, concerns have been raised that this will not occur, particularly given that some relevant contracts will already be in place prior to any implementation of UNC636.

Given the lack of analysis provided to us on these points, we do not consider the relevant parties have demonstrated that the benefits of the proposals outweigh the potentially negative impact. We consider that industry had the opportunity to undertake an appropriate level of analysis and to provide this to us to inform our decision. However, we are mindful that the time taken for industry to develop the modifications and submit to us for decision without such analysis now leaves insufficient time to complete this analysis without significantly delaying potential implementation of the modification. Given that the expectation is that UNC636 would only be an interim solution (as discussed further below), any further delay to potential implementation would mean further uncertainty, which in itself would be not helpful at this stage.

(b) that, so far as is consistent with sub-paragraph (a), the charging methodology properly takes account of developments in the transportation business

The FMR notes that increasing uptake of the OCC over longer distances has led to a need to review the parameters with the OCC rate calculation. Moreover, the FMR says that the rate needs to ensure inefficient by-pass of the NTS is avoided, as failure to do so will increase costs to customers given that allowed revenue will be recovered from a smaller charging base. According to the analysis, UNC636 would reduce the number of routes where the OCC is being utilised.

We acknowledge that the benefits of avoiding inefficient by-pass of the NTS should be weighed against any detriment to competition arising from a cross subsidy among gas customers. We recognise that this is not straightforward. The OCC should constitute a suitable incentive on an ongoing basis to avoid inefficient by-pass of the NTS. In certain cases, the OCC could result in some redistribution from OCC to non-OCC customers. This may be an efficient outcome, provided that redistribution is at an appropriate level.

We are concerned that the modification proposals do not duly take account of the benefits of the OCC. Customers of the NTS derive benefits from the OCC as it provides an additional source of revenue which would not be available should certain network users decide to construct alternative pipelines. We understand the concerns of those

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respondents to the FMR who are concerned that a one-off update after 20 years may undermine previous decisions not to by-pass the NTS, which were made against the current OCC. We also recognise the concerns raised about the annual updating of the formulae and the need for the formulae to be predictable and transparent. However, we would also note that it is important that the OCC represents an appropriate comparison with the potential construction of a pipeline.

Finally, we note that the 'cross subsidy' that UNC636 aims to remedy, may arise in part from the increase in the Standard Commodity Charges; not from the OCC itself. As such, we consider there are benefits to reviewing the OCC as part of the wider-scale reform currently being considered. This would allow the simultaneous examination of the OCC with the Standard Commodity Charges.

(c) that, so far as is consistent with sub-paragraphs (a) and (b), compliance with the charging methodology facilitates effective competition between gas shippers and between gas suppliers

A number of respondents to the FMR noted that the modification proposals will have a negative impact on existing commercial contracts and are liable to cause instability and disruption in the market. They pointed out that many contracts are already in place with customers for the coming gas year, and these reflect the current charging regime. Some respondents considered that re-opening these contracts, which they noted are often subject to long notice periods, will entail a high cost for shippers (relating to the commercial and legal aspects of unwinding trading positions and the subsequent need to design new alternatives). We consider that such disruption may outweigh any potential benefits, given that the proposed modifications are likely to be implemented for one year or less given wider industry reform to implement EU Regulation 2017/460 (TAR NC).[12] In this regard, we also agree with the respondent who noted that if one of the proposals is approved for implementation into the UNC and therefore forms part of the enduring methodology (unless another separate modification is approved with effect from 1 October 2019), then an assessment would be needed against the TAR NC.

The gas industry has been consulting for a number of years on a set of proposals which seek to ensure the compliance of UNC provisions with TAR NC. On 21 February 2017, we published our thinking on the implications for the Great Britain (GB) gas transmission charging regime in light of our Gas Transmission Charging Review (GTCR) and TAR NC.[13] In that document we said we would support the cessation of commodity charges for the purpose of managing under- and over-recovery of transmission services revenue at all points, and that this would include assessing the level of the Standard Commodity

[12] Although we note that the legal text provides for an enduring solution, i.e. there is no end date or requirement for further review within the legal text.
[13] Open Letter: European Union Network Code on harmonised transmission tariff structures for gas (TAR NC) and the industry Gas Transmission Charging Review (GCR) (21 February 2017): https://www.ofgem.gov.uk/system/files/docs/2017/02/gas_transmission_charging_policy_view_21_feb_2017.pdf

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Charge. We think that this reform is the potential opportunity to address the perceived problem of cross-subsidy arising from the excessive increase in the Standard Commodity Charges in recent years. For these reasons, we consider that the modification proposals will not facilitate better charging methodology relevant objective (c).

Our statutory duties

In addition to having considered the Relevant Objectives, we have also given consideration to our wider statutory duties. In carrying out our functions we should also have regard to the principles under which regulatory activities should be transparent, accountable, proportionate, consistent, and targeted only at cases in which action is needed and any other principles that appear to represent the best regulatory practice.[14]

Given the wider scale reform currently under consideration, we think that the OCC should not be looked at in isolation, but should be considered holistically in the context of the wider charging landscape.. This would allow the simultaneous examination of the OCC with the Standard Commodity Charges. A piecemeal approach at this time could create unnecessary uncertainty and undermine long-term planning and effective competition. This would not be compatible with our statutory duties and regulatory principles mentioned above.

Other issues

As highlighted in our urgency decision letter, we agreed with those industry parties who feel that the standard UNC modification process may not be working as effectively as it could. If there are any concerns regarding the UNC modification process, we expect the relevant parties to review whether improvements to the current process may be required.

Decision notice

In accordance with Standard Special Condition A11 of the Gas Transporters licence, the Authority has decided that modification proposals UNC636/A/B/C/D: 'Updating the parameters for the NTS Optional Commodity Charge' should not be made.

Andrew Burgess
Deputy Director, Charging & Access
Signed on behalf of the Authority and authorised for that purpose

[14] More detail on the Authority's powers and duties is available on our website: https://www.ofgem.gov.uk/publications-and-updates/powers-and-duties-gema

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