

RIIO-2 Gas Transmission Policy Working Group

From: Jon Sharvill

Date: 10-10-2018

Time: 9:30-15:30

Location: Energy Networks
Association, 4 More London
Riverside, London, SE1 2AU

1. Present

Geoff Randall, Bogdan Kowalewicz, Martin Siner, Kelvin Hui, Kiran Turner, Lea Slokar, Jon Sharvill, Kirsty Earle (external) (Ofgem)

Alex Ferguson, Carol Carlin, Mike Wassell (National Grid) (NGG)

Julie Cox (Energy UK)

Gregory Edwards (Centrica)

Bill Reed (RWE)

Alison Langford (Exxon Mobil)

Lorna Millington (Cadent Gas)

John Costa (EDF)

Mark Rixon (Engie)

Deborah Hall (Natural England)

James Kerr (Citizens Advice)

2. Introductions

2.1 Participants were introduced and it was explained that views and opinions will not be attributed in the minutes, and the purpose of the working group was for discussion only with decisions not binding on any participants. It was made clear that the slide decks were intended to provoke thought and discussion rather than representing fixed policy decisions.

3. Gas SO Incentives

3.1. Ofgem presented an initial overview of the RIIO-T1 incentive performance to date, highlighting that the SO had made £25m each year from the current incentive scheme, and that NGG had out-performed every target in every year of RIIO-T1 except for GHG emissions. Ofgem explained that the incentives were set at the beginning of the price control, and now as more information is available incentives could be improved by making them more challenging.

3.2 Stakeholders asked if there is scope for any new incentives that give value to customers, to which Ofgem confirmed it was open to any discussions around new incentives. Stakeholders asked if the analysis on SO incentives had been undertaken internally within Ofgem. Ofgem stated that it was based largely on performance data published by NGG and from comments made at

other working groups and meetings. Stakeholders asked what is the right threshold for having to provide evidence and what principles sit behind that.

3.2 Stakeholders noted that the TO side also plays an important role in the SO incentive performance, highlighting the maintenance and GHG emissions incentive. This was accepted by Ofgem.

3.3 Stakeholders highlighted that important information is missing from the analysis on the underlying revenues and revenue drivers, stating that publishing the incentive revenues NGG have received means little without context of how those revenues were generated. Ofgem noted that the level of granularity and disaggregation in the RRs mean that it is not clear exactly what costs are involved in achieving performance levels. Stakeholders stated that if the SO is receiving large incentive rewards there needs to be justification of what has been done to earn those rewards. Stakeholders asked if a performance target is set and NGG work hard to outperform that target, how this can be related back to stakeholder value. Stakeholders suggested that this should be BAU, and incentives need to be awarded for doing something out of the ordinary, otherwise it represents money for nothing.

3.4 Ofgem informed that the majority of incentive revenue earned has been due to the three schemes used to minimise costs. Stakeholders queried the definition of 'schemes' in this context, and whether it amounted to pots of funding. It was explained that some incentives are reputational and some financial, and scheme is the phraseology used to separate incentives from other elements of the price control

3.5 Ofgem presented data showing that the incentives may have generated £133m of net consumer value over five years, acknowledging that customer value is difficult to assess as the counterfactual is unknown. Stakeholders queried who is being referred to as customers, to which Ofgem replied that it referred to users of the transmission network but mainly end-user consumers. Stakeholders asked how the figure of £133m was calculated. Ofgem stated that it believed it represented costs avoided due to the incentives' sharing factor in favour of consumers, but will confirm.

3.6 Stakeholders and Ofgem asked whether any analysis on consumer value had yet been undertaken, to which it was explained that at this stage data has been mainly qualitative rather than quantitative.

3.7 Stakeholders queried what has actually been done by NGG to justify the incentive rewards and whether they have actually gone over and above BAU, noting that system operation is quite different today than when the targets were set, yet performance has remained relatively constant. It was explained that the single figure for incentive rewards does not show the work that goes into achieving the recorded levels of performance and more needs to be done to tell the overall story and highlight the efforts that go into constraint management. Stakeholders stated that it was not just the story that is important, it is also important to set the right incentives to

operate the system when the current situation is very different to how it was when the incentives were first set. Ofgem acknowledged these concerns, accepting that while the £133m figure may be a measure of consumer benefit if the targets are a good counterfactual, if performance is unaffected and consumer benefit cannot be accurately measured then there is a risk the benefit to consumers could be negative. Stakeholders expressed the view that it should be societal benefit, not just consumer benefit, that is taken into account as different consumers have different priorities.

3.8 Stakeholders asked if Ofgem's December document represented the cut-off date for policy decisions and how NGG and stakeholders feed into that, as stakeholder engagement remains ongoing. Ofgem responded that the document only represents the views of Ofgem and should inform the business plan, but it is not a decision document and is meant for guidance and consultation.

3.9 Stakeholders expressed concern that it may be difficult to get a full view on SO incentives within the current timeframe, as it initially took a long time to introduce some incentives and - while acknowledging they are not perfect - suggest removing/changing them at this early stage is premature without having a full grasp of what the alternatives are. Ofgem acknowledged this. For example stakeholders referred to the maintenance incentive which was relatively low value and had only been in place for a few years following industry requests. Whilst it is not perfect there have been significant improvements in the maintenance arrangements since it was introduced and would be concerned if it was removed and there was a risk of reversal of behaviours. The cost to gas fired generators is the opportunity cost of lost generation if maintenance is not well co-ordinated

3.10 Ofgem asked stakeholders whether the output incentives are areas where NGG should be making additional profit or whether it should be embedded into the BAU operation of the network. Stakeholders stated that they wanted to see NG do something that actually 'earns' the profit rather than simply getting the profit as BAU, and justify what they are doing that deserves incentive profitability that they would not have done as an efficient system operator under the license conditions. Stakeholders suggested that the assumption that the current schemes should just roll on is the wrong one and it should instead be down to NGG to devise alternative plans. Ofgem acknowledged this while highlighting issues with information asymmetry when it comes to setting incentive targets.

3.11 Ofgem stated that the incentives should be determined on the basis of value delivered and what the incentive is intended to do. Ofgem accepted that there are issues in the current structure, but broadly believe the areas highlighted on page 11 of the slide deck are areas that should be incentivised, albeit reconstructed. Stakeholders suggested that the incentives should be more dynamic and sensitive to year on year changes, and attention should be paid to the interaction between different incentives.

3.12 Stakeholders expressed reservations that the linepack incentive delivers sufficient value, noting that during the Beast from the East extreme weather phenomenon the incentive did not work, and added around £1bn to gas market consumer costs due to the extra risk taken on by shippers. In response, it was stated that it is not accurate to take these few days of extreme weather as a snapshot to measure the incentive performance.

4. ESO vs GSO Incentives

4.1 Ofgem asked stakeholders whether an ESO-style scheme would be preferable to the current arrangement. Stakeholders noted that the ESO-style scheme is a very recent development and only half way through its first cycle, and therefore it is too soon to judge which method is preferable. Ofgem highlighted the differences between ex-ante and ex-post incentives, asking if the ex-post approach could fit with the current GSO incentives. Stakeholders answered in the affirmative, as the current mechanistic approach has not worked well in providing value for money for consumers. Other stakeholders suggested a combination of both approaches.

4.2 Stakeholders recognised differences between ESO and GSO operations, with gas SO more embedded with gas TO. Stakeholders highlighted the need to explain exactly which costs are SO costs and which are TO costs, giving the example of compressors that are built by the TO but operated by the SO, and the need to distinguish between investment costs and operating costs.

4.3 Stakeholders indicated that setting incentives solely for the SO blurs the line between TO and SO. Stakeholders responded that an integrated approach encourages NGG to optimise internally, which is something that is not always clear to external stakeholders, and more transparency is required so that SO and TO actions can be clearly delineated and incentivised. Other stakeholders stated that synergy in gas transmission between the TO and SO should result in lower costs but there is no clear evidence for that, and it is down to NG to demonstrate that synergy actually exists and how it benefits consumers.

4.4 Stakeholders raised the issue of sharing information across industry so choices about network investment are a combined view in a whole system approach, stating that license conditions are currently a barrier to information exchange. Ofgem accepted this is an area that needed to be looked at and information should be shared more freely.

5. Individual SO Incentives

5.1 Stakeholders noted that constraint management accounts for half of all incentive performance revenue and asked how Ofgem arrived at the figures, to which it was explained that it is the value derived from the incentive formula in the license.

5.2 Stakeholders raised an issue with the forecasting incentive, stating that NGG made the initial forecasts and then outperformed relative to their own forecast. Stakeholders noted that ex-ante

targets and a lack of information and transparency meant that there is no way of knowing if the forecast is right, a problem with taking a mechanistic approach to incentive schemes.

Stakeholders expressed concern about rolling over a mechanistic approach as it is not clear that any additional work beyond BAU has gone towards exceeding targets. It was stated that a lot of unseen work goes into beating incentive targets which may not be done without the incentive. Stakeholders expressed a view that the work should be done as part of the license condition ensuring economic and efficient system operation, and incentives should only be used to encourage behaviour that would not otherwise have occurred.

5.3 Stakeholders raised an issue with the reputational-only incentive concerning data quality, and whether there should be a financial downside to data quality. Stakeholders acknowledged issues with data accuracy, especially when publishing data from third parties, however urged NGG to publish all relevant data while only applying the incentive to data NGG have direct control over

5.4 Stakeholders suggested the current shrinkage incentive was largely as a result of the state of the network rather than NGG performance, and asked whether using a simplistic target is sufficient or whether there are more complex arrangements that need to be looked at. Ofgem explained that the incentive is a result of a number of different variables, such as calorific content, system operation and unaccounted for gas. Stakeholders responded that cost reduction in system operation may incur costs elsewhere through balancing, and a simplistic target not taking into account of the system is undesirable. Ofgem and other stakeholders acknowledged that there are no simplistic answers, and the aim is to find an efficient outcome that integrates behaviours.

5.5 Stakeholders said that it is still at an early stage in the process of updating incentives, and they do not want to prejudge what will be appropriate or not at this stage. General agreement that incentives have to be looked at across the board and acknowledgement that there are a range of possible options without accepting now that an ex-post approach is the preferred option, and that the challenge for Ofgem and NGG is to determine how we want the incentive scheme to actually work in the future.

5.6 Stakeholders stated that the incentive performance overall gives the impression that the targets are too easy to meet, and questioned to what extent these are BAU outcomes. In response, it was explained that lots of time and effort goes into making the targets look easy to meet and more needs to be done to highlight this.

5.7 Stakeholders noted that the linepack incentive may not be necessary throughout the year but only during extreme conditions, and the design for RIIO-2 could reflect this. It was suggested that on operationally challenging days the incentive should be given a different weighting.

6. Capacity Baselines and Access Arrangements

6.1 Ofgem stated that demand for gas is declining, and capacity baselines should be reviewed. Stakeholders acknowledged the reduction in demand however also noted that peak 1-in-20 demand is still a significant consideration. NGG are inviting stakeholders to a meeting in the near future to discuss baselines with industry and try and gain consensus as to precisely what baselines are and the effect they have.

6.2 Stakeholders enquired whether the baselines only concern entry points. Ofgem confirmed that for today's session they did, as there are different drivers and since the last review exit reform has taken place. Stakeholders expressed a worry that the current focus is only on entry and at the last minute exit capacity will be introduced as well. Stakeholders further suggested that Southhook and future entry terminals would be large bespoke arrangements that may require investment and is not coverable by substitution. Stakeholders stated that entry baselines cannot be addressed in isolation as entry and exit baselines are interlinked.

6.3 Ofgem raised the possibility that a zonal approach may be preferable to the current point to point arrangement. Stakeholders expressed concern that the 2021 timeline to implement any changes is not sufficient for the scale of work that would need to be undertaken. Stakeholders noted that investment decisions have been made based on the current regime, and a major overhaul would create uncertainty among shippers on top of uncertainty over what will happen in the new price control. Ofgem acknowledged these concerns, but noted that if action is not taken it will preserve the current distortions leading to incorrectly sized networks. Stakeholders stated that baselines reflect the size of the network, and a baseline review is what is needed rather than creating zonal systems and license conditions. Ofgem reiterated that the slides were for discussion purposes only, and the challenge is how to effectively allocate capacity going forward, and whether current arrangements are supporting this. Stakeholders also noted that zonal access would mean zonal charging, which is a further unknown considering UNC621. Stakeholders also felt that a review of the substitution methodology and user commitment could potentially deliver improvement in capacity allocation.

6.4 Stakeholders asked Ofgem what a zonal arrangement would look like in practise, as substitution is currently based on a nodal basis. Stakeholders also expressed concern that this arrangement will extend to exit as well as entry, and noted that the zonal and nodal models do not look particularly different. Since the key entry points of St Fergus and Milford haven are geographically remote for other points, also that it may not be possible to combine Bacton IP and Bacton UKCS in a zone since access rules for IPs are determined by the EU CAM code. Stakeholders highlighted nervousness around moving to a fundamental review of baselines and moving towards zonal baselines, as it raises big issues that need to be fully debated and baselines are fundamental to how the network is currently accessed. Ofgem acknowledge care needs to be taken with timing and how the process is managed.

6.5 Stakeholders asked Ofgem to ensure that they are clear what the defects are in the current regime as industry may be able to offer solutions, as just having a baseline review means it may be difficult to achieve effective change within the timeframe. Stakeholders also expressed a

preference that entry and exit should be discussed together as price at entry affects price at exit. Ofgem acknowledged both points.

7: National Grid presentation

7.1 Stakeholders enquired as to how NGG will distinguish SO and TO costs in the business plan, and stated that there is no need to have just a single plan based on a combined NGG operation. Stakeholders highlighted the importance of disaggregating SO and TO operations so it can be seen where synergies occur. Stakeholders highlighted potential issues of NGG being incentivised to record assets in the asset base rather than the operating base, and suggested more transparency and justification is required in business plans as to what should appear as an SO and TO cost.

7.2 Stakeholders encouraged clarity when talking about whole systems approaches as to what is actually being talked about. NGG acknowledged this is something that has been discussed in cross-sector workshops, and definitions are being worked on. Stakeholders asked how a whole system outcome can be evaluated, to which Ofgem responded that this has yet to be established.

8. Environmental Output Incentives

8.1 Ofgem noted that the BCF incentive as it stands appears to be having little impact on NGG behaviour. Stakeholders acknowledged this and were open to the idea of including BCF in a cross-sectoral environmental output in RIIO-2.

8.2 Ofgem broached Sustainability First's idea to incorporate an over-arching cross-sectoral environmental incentive into RIIO-2. Stakeholders expressed concern that this duplicated existing environmental incentives. It was explained that this was to be in place of, rather than as well as, existing incentives. Stakeholders were open to the idea providing the incentive is adequately designed.

8.3 Ofgem inquired as to what the focus of the environmental approach should be on in RIIO-2. Stakeholders indicated no clear preference as yet and further discussions need to take place regarding appropriate metrics and performance measurements.

8.4 Ofgem asked whether the focus on low carbon is sufficient or whether a broader sustainability approach would be beneficial. Stakeholders responded that clearer objectives of what the RIIO-2 framework wanted achieve is needed and that we should not be double counting if we are going down the route of cross sector incentives.

8.5 Stakeholders made the point that carbon pricing should be embedded with in all investment decisions and this need to be better embedded in the price control.

8.6 One of the Stakeholders stated that Ofgem should also look at some of the work being done by the ORR and Ofwat. There has been work on natural capital and biodiversity metrics which could be adopted.

Next Steps

Ofgem to specify in the December document the key problem with baselines: Whether it is new access points, decommissioning unrequired assets, capability and flexibility of compressors, or a combination of the three.

Key Dates

7th November – Policy Working Group (needs to be rearranged)

*8th November – NGG Baseline Meeting (TBC)

12th November – GT Cost Assessment Working Group