

RIIO-2 Gas Transmission Policy Working Group

From: Jon Sharvill

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Time: 9:30-16:30

Location: Mary Sumner House, 24 Tufton St, Westminster, London SW1P 3RB

1. Present

Shankar Rajagopalan, Kelvin Hui, James Santos-Mansur, Jon Sharvill, Kiran Turner*, Craig Molyneux*, Scott McDougall*, Kirsty Earle* (Ofgem)
John Perkins, Alex Ferguson (National Grid)
Gregory Edwards (Centrica)
Julie Cox (Energy UK)
Bill Reed (RWE)
Lorna Millington (Cadent Gas)
Anthony Tricot (Ernest Young)
James Kerr* (Citizens Advice)

Item 1: Outputs and Incentives

1.1 Ofgem explained the three new output categories that are being proposed for RIIO-2 and outlined the different types of outputs being considered and how they may be implemented.

1.2 A discussion took place concerning the structure of the December document. It was explained that there will be one overall document and also sector specific documents, with sectors working together to ensure consistency throughout. Stakeholders expressed reservations about the networks being able to achieve cross-sector consistency in the base assumptions, suggesting that the Future Energy Scenarios may be a better starting point.. Stakeholders then recommended a critical review of the December document to find where any inconsistencies have appeared, and to highlight these to stakeholders, to which Ofgem agreed.

1.3 Ofgem discussed how the proposed outputs fit with National Grid's (NGG) stakeholder priorities and the alignment between them. Stakeholders noted that there are areas that do not seem to fit neatly into one of the three new output categories.

1.4 A stakeholder asked what was meant by network capability. Ofgem replied that it is closely related to the physical capability of the network, but it allows for some flexibility which National Grid would be expected to manage through commercial tools at its disposal. Stakeholders added that it is about the size, operation and flexibility of the network, with flexibility and capability being the two most important elements.

1.5 Ofgem showed slides detailing which type of output each of the proposed RIIO-2 outputs would be. Stakeholders noticed a relative absence of price control deliverable (PCD) outputs. Ofgem responded that IED compliance, Network Resilience and large discrete projects could be areas covered by a PCD, and stated that the current categorisation is not set in stone and open to change. A stakeholder highlighted issues with the cyber security and questioned whether this should be a PCD. Ofgem responded that the current plan is to follow legislative guidance and address future changes through an uncertainty mechanism or reopener. A stakeholder stated that at an earlier Working Group PCDs were described as a downside-only, for example penalties for failure to deliver or late delivery, with no incentive for early implementation or delivery. Ofgem responded that there is potential for an output delivery incentive (ODI) on top of any PCD. Stakeholders also expressed the view that when outputs are split between system operator (SO) and transmission owner (TO), they fall into different output categories, which Ofgem acknowledged.

1.6 Ofgem showed where potential T2 outputs fit into the output categories, and stakeholders noted that there may be more potential outputs that have not currently been mapped. Ofgem replied that the outputs are not final and they are happy for NGG to propose new outputs which will then be judged against Ofgem's output criteria.

1.8 Ofgem outlined current thinking on which RIIO-1 outputs it intends to renew, reassess or discontinue in RIIO-2. A stakeholder raised concern that while Ofgem ask stakeholders if they agree or not with the assessment, they have not yet explained fully how that assessment came to be, and asked for the December document, the rationale for Ofgem's position be explained fully.

Item 2: Maintain a Safe and Resilient Network

2.1 Ofgem outlined its proposal that there will be no changes to the safety output in RIIO-2, and invited stakeholder views. Some stakeholders expressed the view that it should be dropped as there is no need for legal obligations to be included as outputs, while others stated that it should be a license condition in order to prevent NGG deciding a fine from the HSE is cheaper than compliance. Further issues were raised concerning Ofgem's ability to competently enforce and monitor HSE legislation, and the difficulty in separating the safety costs of running a network from general network operations.

2.2 Ofgem outlined its proposal to introduce network capability as part of the price control, and proposed that NGGT carry out a review of physical network capability, and consider whether changes to the obligated levels of capacity are required to ensure alignment with the physical capability. Ofgem stated its ambition for any changes to baseline capacities come into force from 2021. Stakeholders expressed scepticism about Ofgem's plans for a review of baselines, stating a belief that it is unnecessary as any network investment that Ofgem deemed inefficient would not be approved anyway, and there are lots of unknowns concerning the FES. Stakeholders stated that the impression is that Ofgem are moving towards a direct like for like alignment between baselines and technical capacity, which would impact the commercial frame and reduce the

flexibility. Ofgem replied that that they are not looking at changing the ways commercial baselines work, and that the primary issue is exposing consumers to risk if baselines are incorrectly set. Stakeholders were concerned that if the network is reconfigured in a significant way in response to changes in baseline capacities, it will have an impact on the ability of shippers to access spare capacity on the NTS. Some stakeholders also stated that they are happy with the flexibility the current arrangement affords them in terms of capacity substitution and reducing baselines could mean taking away capacity that has already been paid for, which could be detrimental to consumers.

Some stakeholders said that the current obligated baselines are more a commercial construct rather than a true reflection of capability: there is a disassociation. If obligated baselines were lowered it could be to the detriment of the access regime due to the impact upon the substitution options. Ofgem said that if there is significant divergence between physical capabilities and commercial obligations, consumers could be exposed to excessive constraint risks and costs.

2.3 Stakeholders noted that the idea of a baseline review sounds complex, and highlighted difficulties surrounding any review, while also urging caution in the use of language used for fears that calling for a baseline review will instil concern in the sector. Stakeholders acknowledged that there is merit in conducting analysis of the capability of the network that ensures network investment in the future is efficient, but recommended it is presented differently and framed around network capability rather than a baseline review.

2.4 Stakeholders asked if Ofgem are expecting NGG to run a review of network capability and baselines modelling exercise and contact industry, to which Ofgem answered in the affirmative and expect NGG to look at this early next year.

2.5 Stakeholders asked if there will be anything in the December document concerning zonal capacity arrangements. Ofgem responded that the onus will be on NGG to determine whether any changes are needed by consumers and whether these changes are appropriate. Stakeholders expressed concern about the difficulty of achieving this within the required timeframe and incorporating it into the business plan in a year will be difficult in light of other ongoing reviews such as UNC 621. Ofgem accepted this and confirmed there will be some flexibility concerning timeframes.

2.6 Stakeholders questioned the benefit of attending working groups, stating that it feels as though they flag issues that could be problematic in the industry, then at the next working group ask if any thought has been given to their views and it does not seem so. Ofgem acknowledged this and stated the intention to get back to stakeholders with current thinking on the issues they raised.

2.7 A discussion took place concerning a network capability incentive in RIIO-2. Stakeholder stated that the issue concerns more than just entry and exit capacity, recognising difficulty in putting

quantifiable measures on many aspects of SO operation. Suggestions included a reputational reporting incentive when customer requirements are not met and a strong license obligation ensuring customers can take gas on and off the network when they want. Stakeholders also suggested line pack, maintaining pressures and pressure deviations are also areas that could be looked at under SO capability.

2.8 Attendees discussed the capacity constraint management incentive, with Ofgem stating an intention to revise the targets in RIIO-2. Stakeholders asked that due to the number of drivers behind this constraint whether Ofgem will be incentivising the drivers separately, to which Ofgem replied in the negative. Stakeholders stated the feeling that this incentive seemed easy for NGG to achieve and it would be more beneficial to treat the actual drivers separately. Stakeholders also stated that it is difficult to comment on this incentive due to a lack of detail of how targets are set. Stakeholder told Ofgem that the December document must clearly outline exactly the problem that Ofgem is trying to fix, and whether a financial incentive is appropriate. Ofgem responded that the objective is to minimise costs to consumers, as constraint costs are costs like any others. Ofgem outlined its position that it is not clear whether the target is still appropriate, and for RIIO2 NGG will propose what the target should be and Ofgem will consider whether that is appropriate.

2.9 The working group discussed the shrinkage incentive, what shrinkage is and how the incentive currently works, and Ofgem outlined its proposal to consider whether to move own use energy element of the incentive into the totex baseline. Stakeholders said that NGG can receive windfall gains through this incentive simply because of gas price changes, and criticised the complexity of the incentive. Ofgem said that it is considering retaining the incentive for the other elements of shrinkage, including calorific value (CV) shrinkage. Stakeholders said there was a need for efficient purchasing of gas for compressors, which is not really shrinkage, and the incentive could be looked at differently. Discussion was about whether GT or GDN's should be incentivised around CV shrinkage (particularly as embedded supplies increase). There was a separate point about whether the shrinkage incentive should focus on physical shrinkage only and could be embedded within an overarching environmental output.

2.10 A discussion was held around the residual balancing incentive. Ofgem said that it is considering whether the linepack incentive is still needed. Some stakeholders said that if the linepack incentive was removed NGG would not trade. Other stakeholders criticised the design of the incentive, stating that it has created an artificial situation that incentivises NGG to get back to where they started the day, regardless of whether the day was started in the correct place. Stakeholders also noted that when the incentive was needed the most – during the Beast from the East extreme weather period – the incentive was not effective and linepack declined, and the incentive does not currently take account of things like weather and seasons. Stakeholders also stated that removing the linepack incentive on its own will not work without thinking carefully about what will replace it, and highlighted the wider market significance of this in terms of sending market signals. Ofgem responded that it will put out to consultation what a more appropriate mechanism could be.

Item 3: Meet the Needs of Consumers and Network Users

3.1 Ofgem outlined its views on the demand forecast quality incentive, stating the intention to retain the incentive and consider introducing an additional D-14 forecast. Stakeholders said that they do not see value in the D2-5 forecast, and asked what evidence exists showing that it provides value to customers. Stakeholders said that shippers do their own forecasting, and what is important is having accurate input data for entry and exit points available. Stakeholders asked which parties actually want the information, and if this is only a small number of parties, questioned whether it is right that everyone ends up paying for it. Stakeholders accepted that NGG should be forecasting, but the issue is whether they should be financially incentivised to do so. Stakeholders asked what problem introducing a D-14 forecast would fix, to which Ofgem responded that some users expressed a desire for a longer-term forecast, and it is an area Ofgem are consulting with stakeholders on to determine if there is value in doing this.

3.2 Stakeholders discussed the maintenance incentive and stated that they did not want to see this removed unless it is replaced with something better and more focused. Some stakeholders said that the incentive was created to change behaviour, which was achieved at a cost, and that now the costs and behaviours are known baseline funding and a license condition to maintain current performance levels could be appropriate. In response, it was suggested that removing the financial incentive may result in worse outcomes for consumers as NGG will not be incentivised to perform efficiently beyond the minimum standard stipulated in the license. Ofgem welcomed these views and stated it will feed them back to the SO team.

Item 4: Deliver a sustainable network

4.1 A discussion was held concerning the GHG emission from venting incentive. Stakeholders indicated that there are decisions to be made with this incentive, as elements outside of NGG's control can have a big influence, and incentives should only be given in areas that are under NGG's control. Participants discussed whether it resulted in NGG effectively being double charged for carbon (because of the EU ETS), to which it was agreed that further analysis was needed.

4.2 Ofgem outlined its proposed approach to emissions compliance expenditure. NGG would be required to produce a five-year plan for compliance with IED which was agreed with the EA/SEPA, and Ofgem would set Price Control Deliverables (PCDs) for investments proposed in its Business Plan as long as these were demonstrably required to comply with emissions legislation, and a proper assessment of options and their costs was carried out. A discussion was held around whether it is more appropriate to fund specific actions or to fund outcomes and let NGG have flexibility in how those outcomes are achieved. Stakeholders questioned what would happen if circumstances change from the beginning of RIIO-2, to which Ofgem responded that an uncertainty mechanism could be appropriate, with claw-back mechanism for any works not undertaken. Stakeholders queried whether the scheme should be wider than just the IED and include all emissions reduction work. Ofgem said that any works proposed must be required to

comply with legislation. Ofgem emphasised the need to strike balance between certainty for NG and a responsibility to protect consumers.

4.3 Ofgem outlined plans regarding the Customers Satisfaction outputs. Stakeholders noted that there was fatigue in terms of engagement and filling in surveys. Stakeholder raised the issue that it is not an issue of quantity of engagement but the quality of engagement and also questioned the robustness of the assessment process for the stakeholder engagement incentive. Not all interactions in the wider forums are meaningful. Stakeholders also queried the need for an incentive for stakeholder engagement when this is now BAU.

4.4 On the Environmental Incentive, Ofgem updated stakeholders on their latest thinking. Stakeholder noted that the proposed mechanism is a bit confusing due to the forward looking aspect, how will the panel judge the level of ambition and achievements? There was the question of ex-post vs ex-ante analysis and the burden of proof for exceptional outcomes – how can do you include exceptional delivery in a business plan as the proof would be after the fact.

4.5 A discussion was held on the appropriate regulatory depreciation period for GT assets. Stakeholders questioned the appropriateness of using 45-year asset lives in T2. A discussion was held around the appropriate definition of asset stranding, and stakeholders stated that given the FES there should be a higher threshold for investment. Stakeholders also expressed concern about taking assets out of the current asset base, to which Ofgem replied that it is not considering to disallow costs that has already gone into the RAV.

4.6 Participants discussed the revenue driver for new entry capacity, and questioned whether it should be done on a case by case basis considering the numbers in RIIO-1 were so low. Stakeholder suggested there could be a de minimus threshold for this kind of review, and Ofgem said this is something that could be considered.

4.7 Ofgem presented the current thinking on innovation in RIIO2. Stakeholders stated that changing more innovation into BAU will lead to a reduction in innovation. Stakeholders suggested decarbonisation of gas, CNG refuelling and electric cars are possible areas where innovation could play a part. A discussion was held around the role of third parties in innovation, to which stakeholders responded that it is useful when looking at areas network companies do not have expertise in, and third companies can be engaged with network company support.

4.8 A discussion was had around what a whole systems approach could achieve in bringing network solutions and how incentives can be used to increase the level of coordinated cross-sector planning. Stakeholders asked what the six mechanisms for whole systems were, and Ofgem responded that this will be articulated in the December document, while acknowledging there are implementation and other issues still to be determined. Stakeholders highlighted in the difficulty in making companies think from a whole systems perspective rather than a company perspective, and questioned what type of thing would fall under this approach. Stakeholders said that if a whole systems approach results in cost reductions for consumers, they would not expect to see

different pots of funding for different sectors. Stakeholders also raised an issue with network company license conditions obligating them to act in an economic and efficient manner, as this approach could lead to inefficient operation within network but result in greater whole system benefits. Ofgem acknowledged this and confirmed it is an area that needs to be looked at. Stakeholders also stated that the solutions a whole system approach is aiming for should not form part of the price control.

Item X: Any Other Business:

Item X: Next Steps: