

Consultation

RIIO-GD2 NTS Exit Capacity Incentive

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We are consulting on NTS exit capacity incentive policy for RIIO-GD2. We would welcome views from people with an interest in exit capacity arrangements.

This document outlines the scope, purpose and questions of the consultation and how you can get involved. Once the consultation is closed, we will consider all responses. We want to be transparent in our consultations. We will publish the non-confidential responses we receive alongside a decision on next steps on our website at [Ofgem.gov.uk/consultations](https://www.ofgem.gov.uk/consultations). If you want your response – in whole or in part – to be considered confidential, please tell us in your response and explain why. Please clearly mark the parts of your response that you consider to be confidential, and if possible, put the confidential material in separate appendices to your response.

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1. Introduction

What are we consulting on?

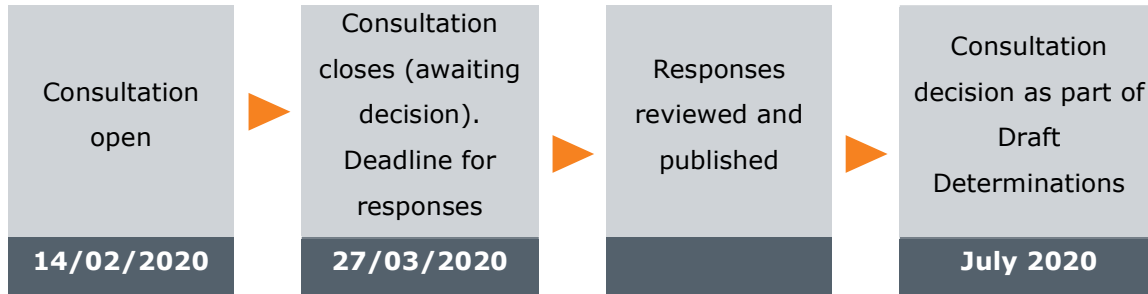
- 1.1. This consultation relates to the National Transmission System (NTS) exit capacity incentive mechanism – an output incentive mechanism that has been operational in the gas distribution (GD) sector under RIIO-GD1. It considers the needs case for the incentive going forward and presents options for its design and application in RIIO-GD2, including its removal.
- 1.2. In our December 2018 RIIO-GD2 Sector Specific Methodology consultation¹, we noted the high level of incentive payments earned so far in RIIO-GD1, and considered possible changes to align the incentive better with actual benefits to consumers. In our RIIO-GD2 Methodology Decision document², we said that due to the interaction between the incentive mechanism and proposed changes to the exit capacity charging methodology being considered under Uniform Network Code (UNC) Modification 678³ (UNC0678), we would defer the decision on the incentive until there was greater clarity on the latter.
- 1.3. Given the recent publication of our minded-to decision and impact assessment on UNC0678, we consider this an appropriate time to consult on the exit capacity incentive for RIIO-GD2 in order to be able to progress this in line with GD Network Price Control draft and final determinations. Since our minded-to decision on UNC0678 is out for consultation we are not seeking responses on it as part of this consultation, neither do we pre-empt the outcome of this related consultation.
- 1.4. To support this consultation, we engaged CEPA/Afry (CEPA) to produce an independent report considering the options for an exit capacity incentive in RIIO-GD2, including the option of removing the incentive. We asked CEPA to review the evidence on the current incentive, and to consider options for RIIO-GD2. CEPA's report is published alongside this consultation and should be read in conjunction with it.

¹ <https://www.ofgem.gov.uk/publications-and-updates/riio-2-sector-specific-methodology-consultation>

² https://www.ofgem.gov.uk/system/files/docs/2019/05/riio-2_sector_specific_methodology_decision_gd.pdf

³ <http://www.gasgovernance.co.uk/0678>

Consultation stages



How to respond

- 1.5. We want to hear from anyone interested in this consultation. Please send your response to the person or team named on this document's front page.
- 1.6. We've asked for your feedback in each of the questions throughout. Please respond to each one as fully as you can.
- 1.7. We will publish non-confidential responses on our website at www.ofgem.gov.uk/consultations.

Your response, data and confidentiality

- 1.8. You can ask us to keep your response, or parts of your response, confidential. We'll respect this, subject to obligations to disclose information, for example, under the Freedom of Information Act 2000, the Environmental Information Regulations 2004, statutory directions, court orders, government regulations or where you give us explicit permission to disclose. If you do want us to keep your response confidential, please clearly mark this on your response and explain why.
- 1.9. If you wish us to keep part of your response confidential, please clearly mark those parts of your response that you *do* wish to be kept confidential and those that you *do not* wish to be kept confidential. Please put the confidential material in a separate appendix to your response. If necessary, we'll get in touch with you to discuss which parts of the information in your response should be kept confidential, and which can be published. We might ask for reasons why.

- 1.10. If the information you give in your response contains personal data under the General Data Protection Regulation 2016/379 (GDPR) and domestic legislation on data protection, the Gas and Electricity Markets Authority will be the data controller for the purposes of GDPR. Ofgem uses the information in responses in performing its statutory functions and in accordance with section 105 of the Utilities Act 2000. Please refer to our Privacy Notice on consultations, see Appendix 4.
- 1.11. If you wish to respond confidentially, we'll keep your response itself confidential, but we will publish the number (but not the names) of confidential responses we receive. We won't link responses to respondents if we publish a summary of responses, and we will evaluate each response on its own merits without undermining your right to confidentiality.

General feedback

- 1.12. We believe that consultation is at the heart of good policy development. We welcome any comments about how we've run this consultation. We'd also like to get your answers to these questions:
1. Do you have any comments about the overall process of this consultation?
 2. Do you have any comments about its tone and content?
 3. Was it easy to read and understand? Or could it have been better written?
 4. Were its conclusions balanced?
 5. Did it make reasoned recommendations for improvement?
 6. Any further comments?


Please send any general feedback comments to stakeholders@ofgem.gov.uk

How to track the progress of the consultation

You can track the progress of a consultation from upcoming to decision status using the 'notify me' function on a consultation page when published on our website.

[Ofgem.gov.uk/consultations](https://www.ofgem.gov.uk/consultations).


Notifications

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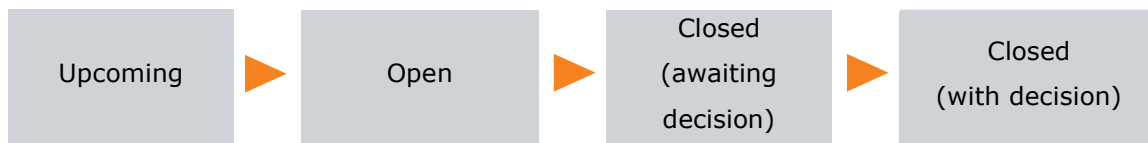
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Once subscribed to the notifications for a particular consultation, you will receive an email to notify you when it has changed status. Our consultation stages are:



2. Considerations for incentivising efficient NTS exit capacity bookings

Section summary

This section provides a brief introduction to existing exit capacity policy in RIIO-GD1, then discusses a number of general considerations and challenges to incentivising efficient exit capacity bookings.

Questions

Question 1: What specific GDN behaviours should any future exit capacity incentive mechanism seek to drive, and what consumer benefit would these deliver?

Question 2: Can you provide evidence of specific actions taken by GDNs in response to the RIIO-GD1 NTS exit capacity incentive, and set out how these have delivered lasting benefits to consumers?

Question 3: Do you agree with the considerations we've identified and the issues associated with them?

Question 4: Are there any considerations, beyond those we've identified, that we should take into account for incentivising exit capacity bookings in RIIO-GD2?

The existing incentive

- 2.1. In order for Gas Distribution Networks (GDNs) to offtake gas from the NTS, they need to book exit capacity from National Grid Gas Transmission (NGGT), which gives them the right to access gas in the future. Current regulatory arrangements under RIIO-GD1 allow the GDNs to pass these costs onto consumers, and so an incentive is in place to encourage efficient booking of capacity. The incentive rewards GDNs for both reductions in the overall level of bookings and greater use of those offtakes that have the most spare capacity (and as such are cheaper). Conversely, the incentive penalises GDNs for booking in excess of preset baseline capacity targets.

- 2.2. The objective of the exit capacity incentive is to encourage GDNs not to book more capacity than they need to meet their 1-in-20 peak demand requirements, and to maximise their use of those parts of the NTS where there is most spare capacity. By encouraging better use of existing capacity, it should benefit consumers by ensuring that peak 1-in-20 capacity is in place at the lowest possible cost.
- 2.3. For a more detailed overview of the existing incentive mechanism, including a review of its performance to date, refer to Section 2 of CEPA's report.

Considerations for RIIO-GD2

- 2.4. In considering the options for an incentive in RIIO-GD2, there are four particular issues that we think need to be taken account of:
- 2.5. **Exit Capacity Pricing:** The methodology for setting exit capacity prices will change from October 2020. As noted in the introduction, we have published a minded-to decision to introduce a "postage stamp" pricing model from this October, but the alternative option of capacity-weighted distance would also see a fundamental change from the current approach. The RIIO-GD1 incentive is structured around the previous charging model, where exit capacity prices reflect the amount of spare capacity at each offtake, and we think this raises an important question over whether the existing approach will still be valid in future.
- 2.6. **Levels of spare capacity:** The NTS now operates with significant levels of spare capacity. Peak demand has come down by around 5% since the start of RIIO-GD1, and the GDNs' Long Term Development Statements forecast that it will remain largely flat over the coming decade (see Figure 1 below). Consequently, it is less clear what value such price signals as may be generated by the incentive will have in future in terms of helping NGGT avoid any unnecessary investment in NTS exit capacity.

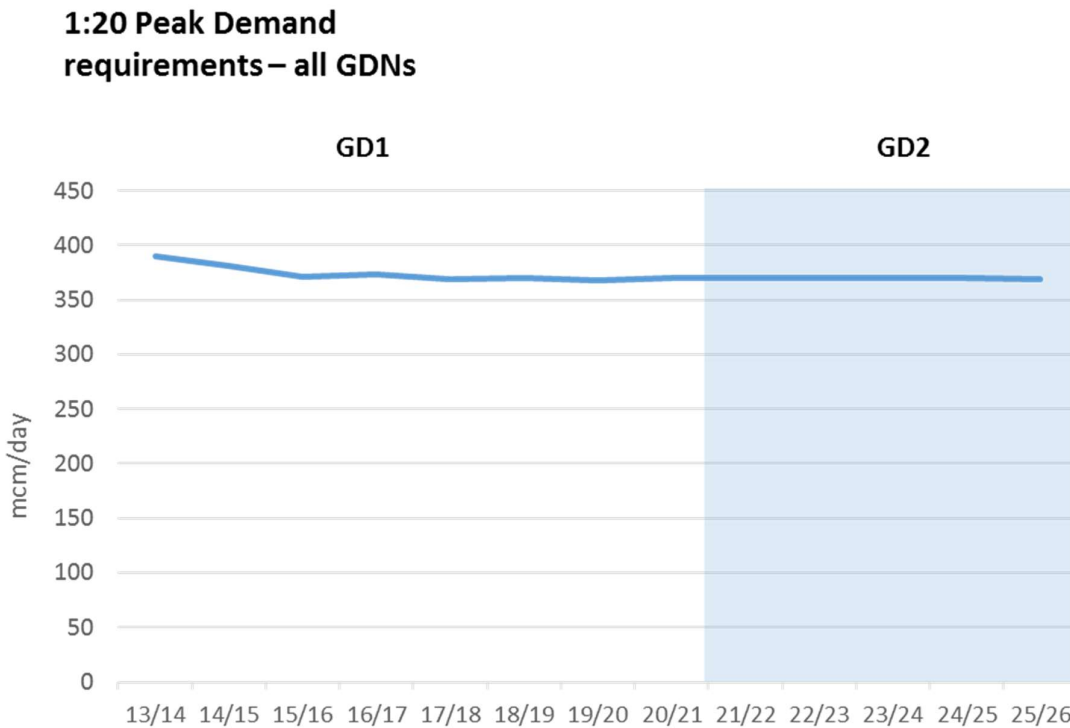


Figure 1: A time trend showing 1-in-20 peak day demand at an industry level over RIIO-1 and RIIO-2.

- 2.7. **Reward/penalty calibration:** In CEPA’s review of the performance of the existing incentive (section 2.2) they note that the associated rewards and penalties are not directly linked to the benefits seen by consumers. The NTS exit charging model is based on a pre-determined level of income for NGGT, with exit capacity prices set at a level that will contribute to this fixed amount. Consequently, there are no direct savings to be made at an aggregate level in the short term purely by reducing flat capacity bookings. While booking reductions may lead to future savings in the form of reduced investment needs, there is no direct link between current prices and the level of future costs avoided. All of this makes it challenging to calibrate the rewards and penalties associated with an incentive, so that these do not exceed the benefits created for consumers.
- 2.8. **Persistence of improvements:** GDNs have consistently outperformed their targets in RIIO-GD1 and have consequently received substantial rewards under the incentive. We would expect these rewards to reflect enduring improvements that have been made to booking processes, which should remain in place whether or not there is an incentive in RIIO-GD2. If the improvements made are not expected to be enduring, they would represent significantly less value to the consumer.

- 2.9. In summary, the start of the next price control, along with the changing nature of capacity charging, presents a timely opportunity to assess the future need for an exit capacity incentive. As such, we seek stakeholder feedback on what specific behaviours should be incentivised, and what consumer value this would generate.

3. Options and Initial Thinking for RIIO-GD2

Section summary

In this section we discuss the various options presented in CEPA's report, followed by our next steps.

Questions

Question 5: Do you agree with the options CEPA has identified, and if not, what others should we consider for RIIO-GD2?

Question 6: Which of the options presented by CEPA is your preference for RIIO-GD2 and why?

Question 7: If we removed the existing incentive mechanism without any mitigations, what are the potential risks and how should these managed?

Question 8: If we remove the existing incentive mechanism, what enhanced obligations could we consider introducing for RIIO-GD2 that would effectively maintain GDN booking restraint? Please provide any specific examples.

Options

3.1. CEPA has identified eight options for RIIO-GD2 as described in Table 3.1 of their report. These options are grouped into the following categories:

- Retain as is;
- Retain as is with an uncertainty mechanism to address the impact of UNC0678;
- Modify incentive;
- Remove incentive, both mitigated and unmitigated.

3.2. Each of the options were then assessed against the following criteria and scored using a traffic-light (RAG) system:

- Does it facilitate gas system efficiency?
- Is it resilient to the outcomes of UNC0678?
- Does it provide value for money for consumers?
- Are there any significant risks?
- Is it difficult to implement?

Initial Assessment of Options

3.3. CEPA's assessment indicates that removing the existing RIIO-GD1 incentive mechanism and replacing it with enhanced obligations is the most effective option for RIIO-GD2. This option performed relatively well in most categories as indicated by green and amber ratings, whereas all other options received at least one red rating, with retaining the existing RIIO-GD1 incentive mechanism scoring particularly poorly.

3.4. Section 3 of CEPA's paper provides full details on their analysis of the options and we have not sought to replicate in detail their views here. Interested parties should review the CEPA paper and we would welcome comments on the details of their analysis.

3.5. It should be noted that CEPA's assessment was carried out before we published our minded-to decision on UNC0678 to adopt a postage stamp charging methodology. Our initial thinking on the options presented by CEPA is set out below and takes this into account, without pre-empting the outcome of the related consultation.

Retain as is / Retain as is with an Uncertainty Mechanism (UM) to address the impact of UNC0678

Description

3.6. Keep the existing RIIO-GD1 incentive, using GDNs' capacity requirements and NGGT price forecasts to set baseline targets, with the option of an uncertainty mechanism to modify, or remove, the incentive based on the outcome of UNC0678.

CEPA's view

- 3.7. CEPA note that UNC0678 (under either option) could lead to changing price signals for efficient capacity bookings, and substantial changes to revenue flows for GDNs as a result of the differences between forecast and actual offtake prices (section 3.2). They suggest that a UM to modify the incentive could be introduced to incorporate the changes to price signals once the decision for UNC0678 has been made and the consequences fully considered. However, they think that a UM is likely to prove complicated to implement. Consequently, they score retaining the existing RIIO-GD1 incentive mechanism relatively poorly compared to the other options they have identified.

Our initial thinking

- 3.8. In chapter 2 we note some of the main challenges associated with the existing NTS exit capacity incentive mechanism that need to be considered for RIIO-GD2. We do not currently think this option sufficiently addresses these challenges. In particular, the existing incentive is based on the assumption that exit capacity prices reflect spare capacity. It will cease to work in the way intended once UNC0678 comes into effect, regardless of the final option taken. In addition, an unchanged incentive would not address the question of what additional long-term value would be gained from further efficiencies in booking, given the current and forecast levels of spare capacity on the NTS. Consequently, we do not currently think that retaining the mechanism in its current form is appropriate for RIIO-GD2, and it is difficult to see how amending it through a UM could address these issues.
- 3.9. The existing incentive has delivered substantial rewards to the GDNs, and we don't think these could be justified in the future if there are no further benefits to be gained in terms of reduced investment by NGGT. While maintaining the incentive would help to ensure that the gains achieved to date are not subsequently lost, our initial view is that there are other ways to safeguard these.

Modify incentive

Description

- 3.10. CEPA outline four potential modifications that could be made, either individually or in combination with each other (section 3.4). These are:

1. **Use alternative prices:** incentive revenue could be based on T-1 or actual prices, as opposed to T-3 prices.
2. **Apply a bespoke incentive sharing factor:** a bespoke sharing factor could be applied to the incentive, as opposed to using the Totex Incentive Mechanism.
3. **Introduce a UM to adjust baselines:** a UM would allow targets to be adjusted in the case of events such as significant changes to a network's 1-in-20 peak demand forecasts.
4. **Discretionary reward:** the incentive reward/penalty would be set entirely separately from the level of booking costs.

CEPA's view

- 3.11. CEPA comment that using alternative prices would be fairly simple to implement and would align rewards more closely with the actual costs being passed through to consumers (section 3.4.1). However, they also note that this would not address the impact of UNC0678, and would still create the potential for forecasting errors in terms of setting baseline capacity volumes.
- 3.12. CEPA state that applying a bespoke incentive sharing factor could make it easier to align rewards/penalties with actual benefits to consumers (section 3.4.2). It would need a decision to be made on the strength of the sharing factor, and does not address any of the issues to do with UNC0678, changes in price signals or changes in demand levels.
- 3.13. A UM to adjust capacity baselines would address some of the uncertainties around target setting and help the incentive reflect the decisions that are within the GDNs' control. However, it could also incentivise the GDNs to inflate their 1-in-20 forecasts.
- 3.14. CEPA note that a discretionary reward/penalty would be more subjective than the current approach, and require NGGT's input on what constitutes efficient booking (section 3.4.4). This option had previously not been appropriate since NGGT's ownership of Cadent gave them a financial interest in the level of incentive, but that no longer applies now that Cadent is independent.

Our initial thinking

- 3.15. Due to timing constraints, both with respect to the RIIO-GD2 price control settlement and the finalisation and implementation of UNC0678, our ability to modify the existing incentive mechanism is limited.
- 3.16. We do not currently think that switching to alternative prices addresses the fundamental issues resulting from the introduction of UNC0678 or the question of what benefit there is in further booking efficiencies. The same can be said of a UM to adjust baselines. Recalibrating the incentive rewards and penalties by means of a bespoke sharing factor would provide a means of aligning these better to the potential benefits that could be delivered in RIIO-GD2, but unless we see strong evidence that fully quantifies these benefits for consumers, we do not think we have a good basis for determining the correct value of this. Moreover, this does not appear to address the issue of whether the incentive would in fact continue to drive efficient behaviour after the introduction of UNC0678.
- 3.17. Moving to a discretionary reward might offer a way to allow for the impact of UNC0678, and could also allow the incentive to take account of wider benefits. However, this would require a complete redesign of the incentive, with several complex decisions needing to be made around how efficient booking should be defined, how it can be measured, and how this could be calibrated to rewards and penalties. Such an incentive mechanism would therefore likely need to be developed independently of the existing incentive, and with cross-sectoral participation. Given the time constraints noted above, it is unlikely that such a mechanism could be fully developed in time for the start of RIIO-GD2.

Remove incentive

Description

- 3.18. Under this option, the existing incentive would be removed, potentially accompanied by enhanced obligations being placed on the GDNs to mitigate any risks that might result from doing so. These could include setting out detailed procedural obligations in the licence, or requiring transparency in booking processes.

CEPA's view

- 3.19. CEPA note that removing the incentive would eliminate an area of the price control where GDNs may have been over-rewarded and that, if future incentive rewards are likely to outweigh future benefits, this would represent a net gain overall for consumers (section 3.5.1). They note, however, that the lack of any incentive to respond to price signals, or reduce bookings, could lead to inefficient outcomes in the form of higher NGGT spending and thus increased consumer charges. However, existing obligations, such as the duty to be "economical and efficient", may help to mitigate this risk. CEPA provide details of how enhanced obligations on transparency could work and note that this would create a reputational incentive for GDNs to demonstrate that their processes continue to be efficient (section 3.5.2). Furthermore, substantial underperformance could be subject to enforcement action.

Our initial thinking

- 3.20. Removing the incentive would mean that the issues identified in Chapter 2 would no longer apply. It would decouple RIIO-GD2 from the finalisation and subsequent implementation of the new gas charging methodology. By retaining a pass-through of NTS exit capacity costs, GDNs would possess the flexibility to react to any unforeseen peak demands imposed on their respective networks without being exposed to potentially unwarranted penalties, and assuming GDNs continue to exercise capacity booking restraint, consumers would be protected in the event that peak demand falls significantly below current forecasts. This option would also simplify the RIIO-GD2 price control.
- 3.21. We recognise that there would be risks to removing the incentive mechanism without any controls in place, most notably the risk that GDNs could exercise a lack of booking restraint without financial implication, booking far in excess of their 1-in-20 peak demand requirements. As CEPA explain, this in itself may have little to no direct financial impact on consumers due to NGGT's fixed exit revenue model (section 2.2), but the inflated demand signals generated by such overbooking may have undesirable longer-term consequences, such as incorrectly indicating the need for NTS reinforcement. However, we currently think this scenario is unlikely, and we expect improvements to booking processes rewarded in RIIO-GD1 to be part of BAU activities in RIIO-GD2. We would also expect GDNs to be engaged in ongoing dialogue with NGGT about future demand, and the potential need for any reinforcement on either

transmission or distribution networks, to ensure that decisions can be made on the basis of all available evidence.

- 3.22. We agree with CEPA's point that differing levels of capacity booking discipline between NTS users, both GDN and non-GDN, could lead to customers on a less disciplined network subsidising those on a more disciplined network (section 3.5.1). This is because, whilst NTS exit revenue is pre-determined at an aggregate level, regional capacity overbooking could distort the profile of revenue recovery across different NTS users. Whilst this is not necessarily an issue that the existing incentive mechanism resolves, it may be exacerbated in the absence of any incentive mechanism.

In light of the above, we think that removing the incentive without any accompanying controls may still result in undesirable risks, and think that placing additional obligations on GDNs around booking processes and data transparency might help to mitigate these risks. CEPA have set out a number of examples such as the publication of the full details of GDNs' exit capacity bookings and an accompanying narrative explaining any changes compared to the previous year (section 3.5.2).

Our preferred option

- 3.23. Based on CEPA's analysis, and our own initial assessment of the evidence available, we do not currently see a case for keeping the existing incentive in RIIO-GD2. Unless we are presented with compelling evidence to the contrary, we do not expect to follow the current approach in RIIO-GD2. Our initial view is that removal of the incentive, possibly combined with enhanced obligations, appears to be the most suitable policy option for the next price control.

Next Steps

- 3.24. We intend to publish all non-confidential consultation responses shortly after this consultation closes.
- 3.25. We will consider the feedback from this consultation as part of our Draft Determinations for RIIO-GD2 which will be published early July 2020. We will then make our final decision in late 2020 as part of our RIIO-GD2 Final Determinations.

Appendix 1 – Privacy notice on consultations

Personal data

The following explains your rights and gives you the information you are entitled to under the General Data Protection Regulation (GDPR).

Note that this section only refers to your personal data (your name address and anything that could be used to identify you personally) not the content of your response to the consultation.

1. The identity of the controller and contact details of our Data Protection Officer

The Gas and Electricity Markets Authority is the controller, (for ease of reference, "Ofgem"). The Data Protection Officer can be contacted at dpo@ofgem.gov.uk

2. Why we are collecting your personal data

Your personal data is being collected as an essential part of the consultation process, so that we can contact you regarding your response and for statistical purposes. We may also use it to contact you about related matters.

3. Our legal basis for processing your personal data

As a public authority, the GDPR makes provision for Ofgem to process personal data as necessary for the effective performance of a task carried out in the public interest. i.e. a consultation.

4. With whom we will be sharing your personal data

We are not intending to share your personal data with other organisations. We are intending to publish non-confidential consultation responses, including any personal data that may be contained within them.

5. For how long we will keep your personal data, or criteria used to determine the retention period.

Your personal data will be held for six months after the consultation closes.

6. Your rights

The data we are collecting is your personal data, and you have considerable say over what happens to it. You have the right to:

- know how we use your personal data
- access your personal data
- have personal data corrected if it is inaccurate or incomplete

- ask us to delete personal data when we no longer need it
- ask us to restrict how we process your data
- get your data from us and re-use it across other services
- object to certain ways we use your data
- be safeguarded against risks where decisions based on your data are taken entirely automatically
- tell us if we can share your information with 3rd parties
- tell us your preferred frequency, content and format of our communications with you
- to lodge a complaint with the independent Information Commissioner (ICO) if you think we are not handling your data fairly or in accordance with the law. You can contact the ICO at <https://ico.org.uk/>, or telephone 0303 123 1113.

7. Your personal data will not be sent overseas

8. Your personal data will not be used for any automated decision making.

9. Your personal data will be stored in a secure government IT system.

10. More information For more information on how Ofgem processes your data, click on the link to our "[Ofgem privacy promise](#)".