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To: David O'Neill / Alsarif Satti
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London, 24th February 2020

Centrica response to "UNC678/A/B/C/D/E/F/G/H/I/J – Amendments to Gas Transmission Charging Regime: minded to decision and draft impact assessment"

Dear David / Alsarif,

Thank you for the opportunity to respond to your consultation on the amendments to the Gas Transmission Charging Regime minded-to-decision and impact assessment and for the significant work you have undertaken throughout this process.

We have reservations about the conclusions reached by Ofgem with the minded-to-decision and we believe that the Modification proposals raised by Centrica (UNC678B) would better strike a balance between achieving the objectives of the amendments (e.g. compliance with TAR NC, review of the RPM) and providing a smooth transition from the status quo.

The answers to the consultation in the following part of this document will provide you with the background to this view.

This response represents the view of the Centrica group of companies. This is response is non-confidential and can be published on Ofgem's website.

We hope you will find this response helpful. If there are any of the points raised in this response that you would like to discuss feel free to contact me at riccardo.rossi@centrica.com.

Yours sincerely,

Riccardo Rossi
Head of Energy Trading Regulation
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Question 1: What is your view of our assessment that Postage Stamp is a more appropriate RPM in light of the circumstances of the GB network? In responding to this question, please address, in particular, the following points in your response:

(i) in a meshed network with spare capacity and declining usage, a fair approach to cost recovery would be based on the level of access to the system irrespective of individual location; and

(ii) CWD may introduce signals for use of the network which discourage flows at more distant entry and exit points, without improving network efficiency.

Summary: A review of the RPM is needed, however LRMC is still superior in determining incremental capacity signals and the outcome of the upcoming rules when combined with PS is far from ideal. CWD and PS should be compared based on consistency with the cost structure of the network and fairness towards gas consumers; cost reflectivity is instead irrelevant. CWD is more consistent with UNC objectives, but we acknowledge that PS may result in lower RRC, at least initially. Ofgem conclusions are not underpinned by rigorous quantitative analysis and we believe that UNC678B is preferable.

A review of the RPM is needed

Centrica agrees with Ofgem that the Long Run Marginal Cost (LRMC) Reference Price Methodology (RPM) is no longer suitable for a network that is undergoing limited expansion and needs reviewing.

We do not share the conclusion that Postage Stamp (PS) is more appropriate than Capacity Weighted Distance (CWD) for the GB gas network. Although the GB gas network has seen spare capacity and declining usage *overall*, we disagree with the implicit assumption that the network will remain completely unconstrained in the future such that locational signals will not have a role in indicating where it is efficient to locate new entry/exit points or increase capacity at the existing points.

LRMC is still superior in determining incremental capacity needs

The LRMC methodology maintains considerable value as it provides the signal for investment and the shipper with the certainty about the payable entry capacity charges for the entire duration of the capacity contract.

Ofgem states in the minded-to-decision that "*If there is a need for future expansion of the network, we consider that this can continue to be managed via the rules established for capacity release in the Methodology Statements and signals regarding whether and where investment should take place*".

However, it is unclear whether this means that the payable capacity price will also remain fixed for the entire duration of the capacity booking. If not, the conclusion reached by Ofgem that "*the proposed changes to the RPM will effectively support the way that market signals are used to determine the need for additional capacity*" is fundamentally flawed because there is no economic rationale for committing to signal an investment and paying an unknown capacity price for the full duration of the contract.

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CWD and PS should be compared on the basis of consistency with the cost structure of the network and fairness towards gas consumers. Cost reflectivity is irrelevant.

CWD and PS are by and large two cost recovery methodologies. Therefore, we believe that cost-reflectivity is irrelevant when assessing the two RPMs. We believe that CWD and PS should be assessed based on their consistency with the structure of the costs that they are intended to recover and the fairness to gas consumers.

In this sense, CWD is more adherent to the cost structure that characterises National Grid: distance and capacity are still important drivers for the investments in the NTS, although we acknowledge their relevance is reducing over time.

Concerning fairness, we believe that the CWD RPM would have more limited distributional effects on all type of consumers when combined with a suitable NTS Optional Charge 1 (NOC 1), allowing for smoother transition to new charging arrangements, while producing a positive consumer welfare.

If we agreed with Ofgem that the focus of the new gas transmission charging regime should be recovering largely fixed and sunk costs of the network, then the Ofgem conclusion would not in any case go far enough to remove distortions in the formation of wholesale gas prices.

CWD is more consistent with UNC objectives

CWD is conducive to enhancing the objectives of 'efficient and economic operation of the pipeline system' and 'it takes into account of developments in the transportation business' and is superior to the LRMC in that it provides for more stable and predictable charges.

A Postage Stamp methodology in our view meets the above objectives less well by encouraging sub-optimal use of the NTS and by ignoring the fact that significant on-going, distance-related expenditure is planned to support and maintain the NTS in future.

The NC TAR states that the costs of transmission services are caused by the cost drivers of capacity and distance (Article 4.1.a) and CWD is the counterfactual methodology against which any alternative needs to be measures against.

PS may result in lower RRC, at least initially

The only benefit of PS is that when determining the Forecasted Contracted Capacity (FCC) an element of complexity is removed i.e. forecast by entry/exit point, hence we could expect – all other things being equal – that under PS the Revenue Recovery Charge (RRC) would tend to be relatively lower. However, in the long run, this benefit can only be marginal.

Ofgem conclusions are not underpinned by rigorous analysis and UNC678B is preferable

In summary, we believe that Ofgem conclusions are rather simplistic and are not underpinned by a rigorous analysis of the consequences on wholesale market functioning and change in market participant behaviour due to the step change proposed with the new charging arrangements, therefore we believe that it underestimates the overall impacts affecting GB gas consumers.

In this sense, we remain convinced that the UNC Modification raised by Centrica (UNC678B or CWD+NOC 1), based on CWD and including a sensible solution for the avoidance of inefficient bypass of the NTS, is a substantial improvement compared with the status quo and it is preferable to UNC678 and UNC678A, as it provides a sensible transition and it is not affected by untested assumptions.

Question 2: Do you agree with our assessment that maintaining the FCC methodology in the UNC improves the transparency and consistency of governance compared to maintaining the FCC Methodology outside of the UNC?

Yes, we agree with Ofgem conclusion. The FCC Methodology is a critical component of the RPM and it is therefore essential that robust and transparent governance arrangements underpin it. For this reason, we agree that the FCC Methodology should be included in the UNC.

Question 3: What is your view on our assessment that the PS RPM would be preferable to the CWD for future green gas market entrants?

In principle we agree with Ofgem's assessment, however we believe it is of little relevance because, in our experience, fewer than 1% of green gas generation facilities plan to connect to the NTS.

Concerning assets connected to the local distribution network, the impact of network charges is minimal when compared with the other OPEX (ca.5%) and therefore unlikely to determine significant locational signals.

Question 4: What are your views on our assessment of the quantitative analysis?

Summary: there are significant limitations in the assumptions taken. There is no consideration for the elasticity of different type of supply and especially for supply highly sensitive to network charging costs and there is an inherent assumption that the marginal supply will benefit from a NOC only sporadically and there is no benefit on the wholesale gas price. We do not believe that this reflects reality. UNC678B is the only modification with no negative impact on any consumer type and the related revenue recovery requirement would be sensibly lower than the status quo[1], hence providing a smoother transition to the new charging regime. The approach taken is inconsistent with the view that Ofgem expressed when rejecting UNC636. The minded-to-decision is detrimental to potential investments in gas storage when comparing the indicative tariffs. The SP scenario is more respondent to the current reality as base scenario.

We believe that there are significant limitations in the assumption taken as they not always reflect market reality, hence in our view the Ofgem assessment of the quantitative analysis is also flawed. This is confirmed by Ofgem in the minded to decision that '*in a number of areas the modelling is sensitive to actual outcome in the market*'.

For instance, Ofgem and CEPA do not consider the different type of supply entering the NBP for which the entry charges can be decisive. In other words, there is no consideration for the elasticity of different type of supply and especially for supply highly sensitive to network charging costs, which may direct flows away from the NBP. This is the case both for flows driven by short term market dynamics (short-term spreads) and long-term contractual

[1] Around £95m, while National Grid calculations for the TS and non-TS socialisation under the current OCC is around £142m, see slide 23 here

arrangements (e.g. LNG SPA). Ofgem confirms this strong limitation in the analysis at point 5.76 and note 71.

We're particularly surprised by the little consideration taken of wholesale market functioning. The consequences of removing a NOC compared with the status quo and the implication on the wholesale gas price at the margin, hence the impact on consumers' bill are treated superficially. Therefore, we believe that whilst the conclusion on the quantitative analysis may prove academically sound, but far from the reality.

Wider system impacts

CEPA concludes that the tariff methodology only has a small impact on the wholesale gas price under any option, "as would be expected"[2]. "*Other things equal, the gas price is slightly higher when a NOC is present".*

In this regard we believe that these conclusions are flawed because there is an inherent assumption that the marginal supply will benefit from a NOC only sporadically and there is no benefit on the wholesale gas price.

Although Ofgem acknowledges that '*in practice, the supply and demand may differ from that modelled, leading to differences in the marginal source, which may impact on welfare estimates'* this invalidates the conclusion that the wholesale price will be higher when a NOC is present.

There is also some confusion on whether the transmission tariffs are seen as part of the wholesale gas price (cause) or, as CEPA infers in some other parts of the report, as a consequence of the level of the transmission tariffs (effect) (5.53-5.57).

These considerations are very important when assessing consumer welfare estimates.

Ofgem confirms that '*the magnitude of consumer welfare benefits of the change to the market prices significantly outweighing the direct benefits of the transmission tariff'.* Therefore, a lack of consideration of the benefits on the wholesale gas price of the marginal supply of up taking a NOC, undermines the conclusion on the impact on net consumer welfare.

On this, it should also be noted that CWD NOC 1/UNC678B is the only modification with no negative impact on any consumer type. And although the overall net positive impact is estimated to be the lowest across the modifications modelled (we believe for the generic wrong assumption above), it is still £300m+ NPV benefit compared with the status quo. Similar consideration can be concluded concerning the estimated bill impact for domestic and non-domestic gas consumers.

Finally, we find rather unusual that, provided that Ofgem considers only 678 and 678A compliant with TAR NC, Ofgem opts for the option that provides a lower welfare for gas consumers based on a perceived better fairness of the PS RPM.

NOC options and take-up and potential for bypass of the NTS

The CEPA analysis might be correct in terms of the overall revenue requirements impact under CWD NOC 1, however we would like to note that the level of revenue recovery requirement under CWD NOC 1 would be sensibly lower than the status quo, hence providing a smoother transition to the new charging regime.

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[2] Paragraph 3.3.2 of the "UNC0678 – Analytical support" paper

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We understand the analysis that CEPA provides when comparing the different NOCs, however we believe that the analysis is missing two important points.

First, the analysis is uniquely forward looking. It may be needed for simplification purposes, but it does not consider all those parties/routes which have continued to contribute to the revenue recovery of the NTS in the last 20+ years under the assumption that the current arrangements would continue.

The second is that the transition from the existing arrangements to no-NOC (or a very limited NOC) will have considerable impacts on those consumers currently benefiting from it, with domino effect in their primary market e.g. wholesale electricity, chemical products, steel production.

It is also useful in this context recalling Ofgem decision on UNC636 on the removal of the OCC: *"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 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."*

Gas Storage

While we can agree with CEPA conclusion that the additional revenue recovery requirement resulting from an 80% discount only lead to a marginal increase in tariffs we have reason to believe that the overall capacity commitments under a PS+80% discount would be broadly similar to a CWD+50% discount and more than double than the capacity commitments with a combination CWD+80% discount. The overall capacity costs for a storage field is several times higher in case of PS+50% discount. Therefore, we believe that the minded-to-decision of Ofgem is detrimental for new investments in gas storage.

Scenarios

Regarding the two scenarios analysed to incorporate low and high level of gas use– Two Degrees (TD) and Steady Progression (SP) respectively – it is doubtful assuming that the TD should be used as central scenario because of the Government decision to adopt a legally binding target of net zero carbon emissions by 2050.

The Government decision reflects a political ambition that Centrica fully embraces, but it has not yet been underpinned by concrete plans to achieve it and National Grid itself has not yet produced a full scenario that would enable the achievement of net zero.

Ofgem therefore as an independent regulatory agency, should use caution it its analysis.

Question 5: What are your views on our assessment of the modification options presented to us against the applicable UNC objectives?

We agree with Ofgem that all options will better facilitate the efficient and economic operation of the NTS relative to the status quo, excluding for the signalling of incremental capacity.

It is without doubt that the main issue of the current regime is related to the high discounts for short term capacity, which leads to most of the revenues being collected via commodity

charges. While this approach is consistent with LMRC methodology, it led to the low income via capacity charges.

As acknowledged by Ofgem in the minded-to-decision, CWD would also provide a better fit for the avoidance of inefficient bypass of the NTS. These considerations, in addition to a reasonable transition, have underpinned Centrica proposals UNC678B which are designed to address the main concerns of the existing regime. CEPA quantitative analysis, although underestimating the positive impacts, confirm this view.

We also appreciate Ofgem views that a '*NOC that is well targeted could add benefits to the efficient and economic use of the network*'. However, we have two main observations on Ofgem's conclusions.

First, Ofgem and CEPA analysis regarding the risk of bypass are only forward looking and do not consider decisions that were taken long ago not to build a bypass under a different economic situation.

Second, Ofgem does not provide a guidance on what can be considered a 'proportionate discount' and although the industry forum is framing a potential proposal, *any* NOC will require additional revenue recovery requirements.

Question 6: What are your views on our conclusion that only two modifications - UNC678 and UNC678A - are compliant with the relevant legislation? If you disagree, please provide a fully reasoned explanation.

We do not agree with the conclusion that only UNC678 and UNC678A are compliant with the TAR NC. The interpretation of TAR NC is not unambiguous and Ofgem is applying discretion in its conclusions. Also, each modification is a composite combination of different elements on which Ofgem view on the 'level of compliance' may differ and the considerations on NOC and storage discount confirm this point.

If compliance with TAR NC was clearly identifiable without discretion, it would have been much appreciated if Ofgem could provide this view earlier in the development process for UNC modification proposals 0621 and 0678 and the UK would have avoided to miss the compliance date of October 2019 of TAR NC.

Question 7

a) Given our conclusion that only two modifications are compliant with the relevant legislation, what are your views on our minded-to decision to approve UNC678A rather than UNC678?

Given that UNC678 UNC678A differ only by the RPM, please see our response to Question 1 on the merits of CWD when compared with PS.

b) Do you consider our minded-to decision to appropriately reflect the principle-based assessment and quantitative analysis presented in this report?

We believe that the principle-based assessment is subjective, and the conclusions reached simplistic and not underpinned by rigorous economic assumptions. Our considerations regarding the quantitative analysis are expressed in reply to Question 4.

c) Do you agree it best facilitates the relevant objectives?

Please fully justify your response.

We disagree with this conclusion and we refer to our responses to Question 1, 4 and 5.

Neither UNC678 nor UNC678A offer a NOC and will therefore have the major negative impacts on certain type of consumers. By pursuing a separate review of optional charges via Review Group 0670R, Ofgem contradicts the opinion provided when rejecting the UNC Modification 0636 proposals that optional charges should be considered as part of the overall package of change.

Question 8: What are your views on our assessment that the proposed RPM (PS under UNC678A) achieves, inter alia, the following objectives:

a) enables network users to reproduce the calculation of reference prices and their accurate forecast.

PS under UNC678A enables users to reproduce the calculation of reference prices and it is simpler than LRMC and marginally easier than CWD. However, equally to other RPMs some crucial variables such as NOC and related revenue recovery requirement, FCC and level of storage discount are crucial elements still missing to enable accurate forecast. Although some of these may be resolved before the start of the next Gas Year, for others like the FCC the uncertainty will remain inherent.

b) presents a better option than CWD for the recovery of the costs of the gas transmission system in the presence of a meshed network characterised by spare capacity and declining usage, and where cost-reflectivity is less relevant;

We disagree with this conclusion especially in the absence of a NOC. For further considerations please see reply to Question 1.

c) ensures non-discrimination and prevents undue cross-subsidisation (you may refer to the results of NGGT's Cost Allocation Assessment ("CAA") published as a subsidiary document to this consultation);

As referred in replies to previous questions, PS does not consider capacity and distance to be drivers of cost recovery, therefore by removing these elements PS discriminates negatively towards those entry and exit points that are very close to each other. Neither UNC678 nor UNC678A offer a NOC, therefore we expect customers currently using the OCC option to be affected.

Ofgem does not provide guidance on what can be considered a 'due' cross-subsidisation, therefore it remains unclear what could be considered as the right balance between cross-subsidisation among different type of consumers because any NOC will require additional revenue recovery requirements.

d) ensures that significant volume risk related particularly to transports across an entry-exit system is not assigned to final customers within that entry-exit system;

We agree with this conclusion, but we note that significant additional cost is assigned to final customers in the island of Ireland compared with the status quo.

e) ensures that the resulting reference prices do not distort cross-border trade?

While the methodology per se does not result in reference prices that distort cross-border trade and the same price applicable at each entry point may seem to be achieving a level playing field, it does not consider the elasticity of supply to network charges, hence PS has implications on the attractiveness of the NBP that CEPA has confirmed at the UNC NTS Charging Methodology Forum that have been ignored in the quantitative analysis.

In addition, the step change in charges and the absence of a NOC will have an impact in the short term, we believe negative, on setting the wholesale gas market price in GB.

Question 9: What are your views on our minded-to decision that implementation should take place from 1 October 2020 to coincide with the start of that gas year?

We are concerned that some important features of the regime e.g. NOC, FCC, storage discount, are not yet clearly defined. Therefore, we believe that it would be more appropriate for all the changes to the transmission charging regime to take in October 2021.

October 2020 seems too ambitious, but we oppose a partial implementation or an implementation in the middle of the gas year e.g. April 2021.

We would appreciate clarity on this point by Ofgem as soon as possible.

Question 10: Are there any other matters, whether or not addressed in our analysis or minded-to findings, which you think we should take into account in reaching our final determination?

We believe that all the proposers and Ofgem have taken the right approach by protecting existing contracts from change in tariffs.

We fully support the view that that Transmission Services RRCs are applied in compliance with the EU Tariff network code (Article 35) and do not result in unjustified or undue discrimination. Therefore, we share the view that they do not apply to Existing Contracts, especially to ensure that they are protected from any form of floating capacity charge or RRC; failure to do this will result in non-compliance with the EU Tariff network code and potential hardship.