Ofgem consultation on gas transmission charging 0678 minded to decision and impact assessment

21 February 2019

About Energy UK

Energy UK is the trade association for the energy industry with over 100 members spanning every aspect of the energy sector – from established FTSE 100 companies right through to new, growing suppliers and generators, which now make up over half of our membership.

We represent the diverse nature of the UK's energy industry with our members delivering almost all (90%) of both the UK's power generation and energy supply for over 27 million UK homes as well as businesses.

The energy industry invests over £13.1bn annually, delivers around £85.6bn in economic activity through its supply chain and interaction with other sectors, and supports over 764,000 jobs in every corner of the country.

Energy UK welcomes the opportunity to comment on this minded to decision, we provide comments against the questions below:

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.

Energy UK notes that the complete removal of any form of locational signal is a significant move away from the charging regime that has been in place for many years. It also seems to implicitly assume 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 connections. It is entirely possible that new connections for gas generation, biomethane, and Hydrogen production could occur in locations that require investment and these would not be discouraged by a postalised charging regime, potentially leading to inefficient network investment. A stable regime is required to facilitate investment to support the decarbonisation agenda and further change in a few years to address problems arising from lack of locational signals today would not be desirable.

Energy UK agrees in principle that Postage Stamp (PS) may be a more appropriate pricing methodology in a meshed network with spare capacity, where location is not a key driver of cost and the focus is on cost recovery. However, this only the case where there is no risk of new connections, triggering investment.

The capacity weighted distance methodology (CWD) as applied to the GB network produces disproportionately high prices at points with high weighted distances, even where an exit point is very close to an entry point and in such locations does not reflect the cost of gas flowing such a short distance. Deterring such flows would not improve network efficiency. So, this approach whilst potentially providing locational signals may not be providing signals that are cost reflective.

Energy UK notes that both the PS and CWD approaches diverge from the arrangements being developed for the electricity market and this could become a barrier to sector coupling.

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 consider that including the FCC methodology in the UNC will provide better consistency of governance for this key part of the charging methodology than an alternative process. Within the UNC the principles or transparency and fairness can be upheld, whilst parties that are subject to the charging arrangements can raise modification proposals. It would be illogical for the FCC methodology to be subject to any other form of governance when the charging arrangements are within the UNC

A key premise of the methodology is that the FCC should reflect expected bookings, and there are a number of deficiencies including transparency of input data that need to be addressed. We hope that these issues and those identified by Energy UK in March 2019 and included in our response to the 0678 consultation[1] will be more thoroughly considered before the methodology is incorporated into 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?

Paragraph 4.138 provides limited insight into Ofgem's assessment, and green gas almost always connects to the distribution network so there is limited impact of NTS charges. From the perspective of fairness of charges and predictability, in principle, PS would be a more equitable approach than CWD, but this would not recognise the risk of such connections creating constraints or needing network investment

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

Given Ofgem's view on compliance and assessment noted in Question 1, it would seem that the quantitative analysis carried little, if any, weight in Ofgem's determination. Therefore, it is largely irrelevant.

[1] https://gasgov-mst-files.s3.eu-west-1.amazonaws.com/s3fs-public/ggf/book/2019-05/Representative%200678%20-%20Energy%20UK.pdf

If the analysis had been a key influence on Ofgem's decision we would have significant concerns, there were a number of issues which had not been adequately addressed. An opportunity was provided for stakeholders to submit questions on the analysis, subsequently a verbal and written commentary was provided. However, concerns remain relating to the articulation of the status quo being modelled rather than a representation of the current arrangements, particularly when the results of the modelling produced such small changes in prices which do not intuitively seem to be robust. Also, with respect to the modelling of storage showing that a storage discount of 80% results in the largest decrease in customer bills and the detrimental impact on storage revenue impacting financial viability of such facilities, which may close or be mothballed.

The outcomes should therefore be treated with caution and we do not have sufficient confidence in the analysis to determine whether the impacts on customers have been accurately presented to determine whether their interests are protected in the short and long term.

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

Energy UK welcomes Ofgem's recognition that a well-designed optional charge available to those sites where bypass is a genuine option and with an appropriate discount could have benefits for network efficiency.

We agree with the view that, at the current time, cost recovery is more important for the current network than cost reflectivity, whilst recognising properly justified discounts may be appropriate for storage capacity given its role in security of supply. The CEPA analysis did not consider the impact of price spikes and price volatility and the role that storage could have in mitigating these.

See comments under question 6 in respect to the relevant objective for compliance.

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.

The interpretation of a complex set of rules that interact and overlap as present in TAR NC means compliance is not a simple black and white issue. This is clear since Ofgem did not provide this view earlier in the development process for UNC modification proposals 0621 and 0678. Also, that seven months elapsed from the final modification report being submitted to Ofgem for decision and for their minded to decision to be published.

It is the case that the proposers of all the alternatives believed their proposal to be compliant and some sought specific and detailed legal advice supporting their views[2], yet Ofgem has a different view.

[2] https://gasgov-mst-files.s3.eu-west-1.amazonaws.com/s3fs-public/ggf/book/2019-03/Article%2035%20Legal%20Advice%20%28provided%20by%20SSE%29.pdf

In taking this view of compliance Ofgem puts existing contract holders in a more favourable competitive position than they are today, where they currently pay revenue recovery charges, but in the future will not.

Ofgem's view on compliance also eliminated a number of proposals which included a higher discount for storage capacity and an optional charge for exit points which are very close to entry points. Ofgem recognises that further proposals to address both issues could be progressed so long as in the case of storage the larger discount is well justified and in the case of an optional charge it is limited to where there is a credible risk of bypass. For the storage discount Ofgem provides some guidance in 4.54 about what may help to justify a larger discount. For an optional charge, no guidance is provided on how a 'credible risk of bypass' would be assessed, should such a proposal be progressed. Yet it would clearly not be in wider consumers interests if the lack of such arrangements led to parties bypassing the NTS altogether, such that revenue would be lost from theses flows and tariffs to all other customers would rise. We reflect on Ofgem's comments in its decision for UNC modification 0636[3]

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

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

It seems that Ofgem recognises having some form of optional charge could be an efficient solution, but we have now arrived at a piecemeal approach. We therefore encourage Ofgem to more fully engage with industry to develop an efficient enduring solution in a timely manner and avoid the risk of bypass. If such arrangements are not in place for the proposed October 2020 implementation date, then we suggest the implementation date should be October 2021. This would also have the added benefit of certainty over the RIIO2 price control settlement which an October 2020 implementation does not.

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

[3] https://gasgov-mst-files.s3.eu-west-1.amazonaws.com/s3fs-public/ggf/book/2018-07/Ofgem%20Authority%20Decision%20Letter%20UNC0636%20310718%20D.pdf

c) Do you agree it best facilitates the relevant objectives?
Please fully justify your response.

a) In a simple consideration between 0678 and 0678A we agree with the minded to decision see comments under question 1
b) & c) we consider the quantitative analysis to be largely irrelevant. Also see comments under question 5 and 6 with respect to an optional charge and storage discounts

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;

As the postage stamp methodology requires relatively few inputs it enables users to calculate reference prices more readily than other more complex methodologies. However, the FCC is still determined for each point on the system then aggregated for the PS methodology rather than input to a model to determine CWD charges. The model has been published. Either approach depends on the availability of the required data inputs over the desired time frame. Prices should also become relatively stable over time

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;

See 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);

Cross subsidies will always exist in a charging regime where charges are not fully cost reflective. Neither the PS nor the CWD contain fully cost reflective charges, and as we do not have specific cost information, we do not know which approach produces the least cross subsidies. The formula is only a very simple proxy for cross subsidisation.

In principle, charging users the same price at entry and exit, apart from existing contract holders that are protected by Article 35, and storage capacity discounts recognised in Article 9, would seem to minimise cross subsidisation where cost recovery is the main aim of the reference price methodology. Applying the same price for short term and long term capacity and pricing interruptible capacity a price that reflects the probability of interruption also addresses issues of non-discrimination and cross-subsidisation.

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;

As capacity at interconnection points (IPs) is priced in the same manner as capacity at other points then there is no bias towards revenue recovery from final customers

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

Setting charges at all IPs using the same methodology whether that is PS or CWD should not distort cross-border trade once the arrangements are in place. However, the step change in charges and their structure at the introduction of the new arrangements will influence the price differentials and trading dynamics between markets for gas to flow.

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?

Energy UK understands that an October start date is necessary because of the rules in TAR and CAM which require charges to be set once a year for an annual product. As the capacity year begins on 1 October then this defines the start date for implementation.

We do however have some concerns over the notice period and when actual charges will be published, to enable shippers and suppliers to plan and implement these substantial changes in contracts and tariffs in an efficient manner to enable a smooth transition and minimise costs to industry and end users. These arise from the significant change in the structure of the charges and potential uncertainty as to how the distribution networks will recover charges from suppliers, including whether they will seek to amend their allowances in a shorter timescale than would normally be the case. These issues mean that suppliers face particular challenges in ensuring the new transmission charges are properly reflected in customer tariffs.

October 2021 would be a better implementation date to allow time for the storage discount and optional charge to be addressed, to better take account of the new price control period and to provide adequate notice to allow customer tariffs to be updated.

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?

A key issue will be timing of the final decision to allow sufficient notice of charges for interconnector and exit capacity allocation processes and to ensure the tariff changes are efficiently reflected in customer tariffs. This needs to be considered in conjunction with proposals for storage discounts and optional charge arrangements which may or may not have progressed through the UNC modification process at this time. Lack of clarity over the governance of such proposals being raised prior to the 0678 decision adds to uncertainty in this regard and would also suggest an implementation date of October 2021 would be more appropriate.

With respect to storage Ofgem should also consider more fully the risk of closure of facilities in the short and medium term in the context of the decarbonisation agenda and the potential requirement for storage for natural gas / hydrogen blend or 100% hydrogen at some point in the future.

Summary:

Energy UK broadly supports Ofgem's minded to decision with respect to UNC 0678A with the postage stamp methodology being more appropriate for the current GB system in the short term for cost recovery and to achieve compliance with TAR NC. We agree this is a suitable way of supporting competition, and minimising cross-subsidisation. We do however have concerns that the lack of any sort of locational signal as to where parties should efficiently connect could create or exacerbate constraints in the future.

We also consider that this represents a significant step change in the current charging arrangements which will have wider consequences, including in the electricity market. The issues of the storage discount and optional charge need to be addressed to avoid the undesirable consequences of the closure of storage facilities or bypass of the transmission system, which would not be good outcomes and would increase the cost burden on customers in the medium term. Energy UK would therefore support an October 2021 implementation date to allow these issues to be addressed and ensure a well managed transition.

We also have concerns that this approach is not consistent with that for the electricity regime and may not promote efficient outcomes in support of the decarbonisation agenda, in respect of sector coupling and low carbon gases.

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