EP UK Investments

Response to Ofgem consultation on Amendments to Gas Transmission Charging Regime: minded to decision and draft impact assessment

24 February 2020

Executive Summary

- The proposed RPM would lead to disproportionately high costs for offtakes located close to entry points and must therefore be accompanied by a shorthaul' tariff to discourage construction of private bypass pipelines.
- Complete removal of the current shorthaul tariff would lead to a significant increase in costs for some CCGTs, which it will be difficult to recover through electricity capacity or wholesale markets.
- If power stations lose shorthaul, they will investigate all possible options to reduce costs, including building bypass pipelines. This may lead to outcomes which Ofgem has not foreseen. Ofgem's analysis contains methodological flaws that appear to underestimate the risk of users building bypass pipelines.
- We do not agree with Ofgem's finding that NOC Methodology 2 provides an undue cross-subsidy to sites with no credible risk of network bypass. This shorthaul methodology is based on the estimated cost of building a bypass pipeline and Ofgem's primary criticism of Methodology 2 appears to misunderstand how it works.
- We therefore consider that Ofgem must direct that a shorthaul tariff will be retained and that, if the eligibility for the shorthaul tariff and/or level of shorthaul discount is to be reduced, any change should be phased over a number of years.
- It important that network users have an opportunity to respond to any changes in network charges and are given appropriate notice of their implementation. We therefore consider that gas charging reform should be implemented from October 2022 at the earliest, with any changes to the shorthaul tariff phased from that point.

About EPUKI

EP UK Investments (EPUKI) is a UK energy company, primarily focusing on power generation from conventional and renewable sources.

EPUKI represents the UK and Ireland interests of Energetický a průmyslový holding (EPH), a leading Central European energy group that owns and operates assets in the Czech Republic, the Slovak Republic, Germany, Italy, the UK, and Hungary. EPH is a vertically integrated energy utility covering the complete value chain ranging from highly efficient cogeneration, power generation, and natural gas transmission, gas storage, gas and electricity distribution and supply. EPH is the 6th largest producer of power in Europe, employing over 25,000 team members.

In the UK, EPUKI owns Langage and South Humber Bank combined cycle gas turbine (CCGT) power stations, with a combined capacity of 2.3 GW, as well as the 420 MW Lynemouth biomass power station. EPUKI actively pursues other acquisitions and new build opportunities in the GB electricity market, including two new build CCGT projects at Eggborough and King's Lynn, with a combined capacity of 4.3 GW. In 2019, EPUKI acquired the Ballylumford gas-fired power plant, Kilroot coal and oil-fired power

plant, and Kilroot Energy Storage facility in Northern Ireland. EPUKI is also the majority shareholder in Tynagh Energy Limited, a 400 MW CCGT in the Republic of Ireland.

EPUKI welcomes the opportunity to respond to Ofgem's consultation on its 'minded to' decision on UNC0678 and its alternatives. Gas charging reform could fundamentally alter the economics of gas-fired power stations and EPUKI is keen to ensure that Ofgem is aware of all the consequences of its decision. We have provided an overview of our concerns below, followed by a response to the questions posed in the consultation document. We have also provided additional commercially-sensitive information in a confidential annex to this response.

General comments

EPUKI's primary concern is that the modification which Ofgem proposes to implement (UNC0678A) does not contain any form of Optional Charge or 'shorthaul' tariff. We consider that shorthaul remains an important tool to prevent inefficient bypass of the NTS. Without it, there is a strong possibility that some power stations and industrial sites may build private bypass pipelines or may face significant unrecoverable costs that could impact their lifetime and operations. EPUKI does not support any gas charging reform proposal that does not address the risk of bypass through the use of a shorthaul tariff.

Implementation of UNC0678A would completely remove shorthaul and would have a serious detrimental impact on individual offtakes. Shorthaul is an established concept that has been in place since 1998 and companies' investment decisions have been taken on the basis of its continued existence. Many companies would have invested in bypass pipelines in previous years if they had known that a shorthaul tariff would not be enduring.

We consider that removal of shorthaul would lead to a credible risk that many offtakes would bypass the NTS. Ofgem appears to have underestimated this risk in its analysis for reasons explained in the detailed answers to the consultation questions. We do not find Ofgem's analysis that only three additional offtakes would present a credible risk of bypass under a postage stamp methodology without shorthaul to be reasonable.

The complete removal of the shorthaul product would lead to a significant increase in costs for offtakes located within circa 30 km of an entry point. These users will investigate all possible options to reduce costs, including building bypass pipelines. The site-specific nature of these considerations and the desire to innovate to reduce costs may lead to outcomes which Ofgem has not foreseen. An example for one offtake is contained in the confidential annex to this consultation response. We can see no reason why this kind of thinking would not be replicated across many different offtakes.

Ofgem accepts that a suitably designed shorthaul tariff may have benefits in terms of efficiency of network use. EPUKI maintains that the most appropriate way to ensure that a shorthaul tariff is appropriately targeted and reflects the risks of system bypass is to adopt an approach that is reflective of the cost of building a bypass pipeline, similar to NOC Methodology 2. Any approach containing a distance or cross-subsidy cap would be arbitrary and is likely to lead to unintended consequences which had not been foreseen.

We note that the concept of providing discounts to large loads located close to entry points also exists on gas distribution networks through the Optional LDZ Charge and that there is no proposal to remove this discount. We consider it would be inequitable to remove shorthaul discounts on the transmission network but not the distribution networks. This could give an unfair advantage to power stations connected to the gas distribution network over those connected to the NTS.

The removal of the NTS shorthaul tariff will disproportionately affect key industrial areas, such as the Humber region or Teesside, which are located closest to gas entry terminals. As well as direct impacts on gas charges for industrial customers, there will be periods in which power stations currently using shorthaul set the power price and removal of shorthaul could therefore push up electricity prices for industrial consumers, who are already struggling with high energy costs. We are concerned that Ofgem has not considered the potential impact of reduced profitability from the removal of the shorthaul tariff on the regional economy and the government's industrial strategy. It should also be noted that these areas are likely to be central to the government's decarbonisation ambitions as they will be key locations for the roll of out of technologies such as carbon capture, usage and storage and hydrogen production.

Ofgem should therefore be wary of the impact on investor confidence in these regions resulting from the removal of the shorthaul tariff.

EPUKI considers it important that network users have an opportunity to respond to any changes in network charges. The proposed implementation date of October 2020 for gas charging reform means that users will only have a few months in which to adjust their business strategies to accommodate Ofgem's final decision. Sites currently benefiting from shorthaul will have no way in which to mitigate the increased costs if the tariff is removed. Design, permitting and construction of a bypass pipeline could take several years. Complete removal of the shorthaul tariff (or even a substantial reduction in the shorthaul discount) would therefore simply add significant cost to some offtakes which could not be avoided for a number of years.

The immediate removal of shorthaul would also undermine decisions that have already been taken by power stations. Generators would usually seek to recover their fixed costs through the electricity capacity market and their variable costs through the wholesale electricity market. Power stations utilising shorthaul will soon have entered into electricity capacity market agreements through to September 2024 at a clearing price determined on the basis of their current expected operating costs. Generators would therefore be unable to recover any increase in fixed costs through the capacity market in this period. Any attempt to pass through increased variable costs in the electricity wholesale market would make individual power stations more marginal and therefore less competitive. The removal of shorthaul prior to 2024 would therefore simply expose power stations currently benefitting from the tariff to additional costs which they are unable to recover.

The impact of removing shorthaul or substantially reducing the shorthaul discount in October 2020 would be to undermine investor confidence. EPUKI considers it important that regulatory reform is clearly signalled and implemented on a reasonable timeframe. Although the gas charging reform process has been ongoing for several years, Ofgem has not previously given a clear indication that the shorthaul tariff would be entirely removed. Although there is industry activity outside of the UNC0678 process to develop an alternative form of shorthaul tariff to apply from October 2020, there is no assurance around the design of this or whether it would be approved by Ofgem. This gives no certainty to industry participants. Ofgem should therefore consider the Optional Charge to be an integral part of gas charging reform and not assume that changes to shorthaul can be made on a piecemeal basis.

EPUKI therefore considers that Ofgem must direct that a shorthaul tariff will be retained from October 2020 and that, if the eligibility for the shorthaul tariff and/or level of shorthaul discount is to be reduced, any change should be phased over a number of years. These measures would reduce any immediate significant negative impact to companies and give offtakes an opportunity to respond to the altered charging regime, for example by building bypass pipelines where possible. A phased approach to the removal of benefits has previously been adopted in electricity, for example when implementing changes to electricity transmission charging arrangements for embedded generators (CMP264/5).

Response to consultation questions

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.

Both RPMs would lead to disproportionately high costs for offtakes located close to entry points. EPUKI therefore does not consider that either RPM is appropriate unless it is accompanied by an Optional Charge ('shorthaul' tariff) to address this issue and discourage the construction of private bypass pipelines.

Given that both RPM methodologies are cost-recovery mechanisms, in general we consider that a postage stamp approach would be preferable if accompanied by a shorthaul tariff for the reasons identified by Ofgem.

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.

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?

We do not consider that either RPM would necessarily be preferable to green gas market entrants. However, Ofgem should consider how the proposed removal of the shorthaul tariff could affect the attractiveness of hydrogen production and grid injection in industrial areas (eg. Humberside).

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

As recognised by Ofgem and CEPA, there are major simplifications, assumptions and omissions in their quantitative analysis. We are concerned that these serious deficiencies call into question the analysis' accuracy and reliability as a basis for decision making.

- The CEPA analysis begins in 2022. This overlooks two years in which the new charging arrangements would be in place if Ofgem proceeds with an October 2020 implementation date. We are unclear why this period has not been modelled as it is the one in which the impact on gas and electricity market participants is likely to be greatest as they will already have entered into some contracts covering these years. For example, power stations entered into electricity capacity market agreements through to 2022 over two years ago when there was no indication of what gas charging reforms might be in place. Ofgem's analysis therefore ignores the immediate impacts of the reforms.
- The analysis shows a significant reduction in electricity market revenue for power stations, but suggests that this is offset by positive electricity consumer welfare impacts. However, this analysis excludes any modelling of the electricity capacity market. This is a major failing of the analysis as to remain profitable generators are likely to seek to recover lost revenue through the capacity market, which could offset some of the modelled consumer savings.
- The risk of NTS bypass is understated in the analysis as the modelling excludes any consideration of SO/non-transmission service charges. These are costs that shorthaul users currently avoid and would be a major consideration in any bypass decision. The non-transmission service charges will be a significant proportion of overall network charges and not to include them in any assessment is a major failing. We also question some of the other assumptions made in the bypass modelling, such as the pipeline costs and payback period. Although this modelling will always be indicative, the low risk of bypass shown in the modelling is a major factor in Ofgem's willingness to remove shorthaul completely and we therefore consider that all factors must be given proper consideration. As shown elsewhere in this response, there are a range of bypass options available to offtakes which Ofgem may not have appreciated and it would therefore be preferable to err on the side of caution when considering the risks associated with bypass.

We note that one of Ofgem and CEPA's major concerns with NOC Methodology 2 is that it does not contain a load factor adjustment and therefore results in an undue cross-subsidy. Ofgem states that under Methodology 2 the NOC discount is calculated on the basis of a 100% load factor and assuming a lower load factor would lead to the costs of a bypass pipeline being recovered over a smaller volume of flows, 'hence making a bypass pipeline less commercially attractive than the design of the methodology assumes'. This appears to be a misunderstanding of NOC Methodology 2.

In NOC Methodology 2, a range of annual pipeline costs is calculated for different distances and pipeline sizes to accommodate peak flows. A 100% load factor is assumed to convert these annual costs into a p/kWh cost, from which a general formula is derived. The p/kWh cost for an individual offtake using shorthaul is then converted back into a fixed daily bypass pipeline cost using the offtake's MNEPOR (ie. an 100% load factor). Using the same load factor at both these stages ensures that the formula is logical and consistent and that users end up paying the full bypass pipeline cost, which is then spread over their expected capacity bookings (FCC). The minimum annual charge in the methodology ensures that users pay as if they flowed at a 100% load factor for a whole year and therefore pay the equivalent

cost of building a bypass pipeline. We therefore do not understand Ofgem's criticism of the formula in this respect and would be pleased to discuss the operation of NOC Methodology 2 in more detail.

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

In respect of Objective (a), we support the conclusion set out by Ofgem in paragraph 6.7 that an appropriately designed shorthaul tariff could have positive benefits for network efficiency. However, we do not agree with Ofgem's conclusion that NOC Methodology 2 is not targeted effectively at those routes that pose a risk of bypass. As explained above, we consider that Ofgem's analysis understates the risk of bypass (particularly in not considering non-transmission service charges) and we have evidence that the range of credible bypass options at individual offtakes may be greater than Ofgem has realised. Given that NOC Methodology 2 calculates the shorthaul tariff based on up-to-date bypass pipeline cost data, we cannot agree with the finding that it is not appropriately targeted.

Given our finding that the level of shorthaul discount proposed under NOC Methodology 2 is justified, we also do not agree with Ofgem's conclusion in paragraphs 6.14 and 6.17 that the NOC methodologies are discriminatory and inappropriately targeted.

We consider an NTS Optional Charge would provide an ongoing incentive to flow gas onto the NTS rather than through private bypass pipelines and is therefore likely to improve gas security of supply in general by ensuring ongoing use of a shared transmission network, better facilitating Objective (e) relating to security of supply.

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 Ofgem's conclusion. Ofgem considers that all modifications containing NOC Methodology 2 'provide an undue cross-subsidy to a number of network users for whom our analysis suggests do not present a practical risk of network bypass'. The applicable tariff under NOC Methodology 2 is based on the expected cost of building a bypass pipeline. Contrary to Ofgem's understanding, the use of MNEPOR in NOC Methodology 2 does not underestimate the cost of building a bypass pipeline and therefore does not result in undue cross-subsidy. Furthermore, we consider that Ofgem's analysis underestimates the risk of users bypassing the network by failing to consider non-transmission service charges and alternative options for network bypass.

Given that undue cross-subsidy appears to be Ofgem's only concern about the compliance of NOC Methodology 2 with the relevant legislation and we do not consider that Methodology 2 results in undue cross-subsidy, we cannot agree with Ofgem's overall compliance assessment for these modifications.

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?

Both UNC0678 and UNC0678A are deficient because they do not contain any form of NTS Optional Charge and we consider that Ofgem should either not approve any modification that does not contain a shorthaul tariff or should direct that an Optional Charge must be adopted alongside any approved modification that does not contain one.

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

As explained above, we consider that there are major flaws in Ofgem's assessment of NTS Optional Charge Methodology 2 and we therefore consider that the minded to decision is consequently flawed. We note, for example, that Ofgem considers NOC Methodology 2 to deliver an undue cross-subsidy because it assumes that users flow gas equal to their MNEPOR. As explained above, this is a misunderstanding of the methodology.

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

No, we do not consider that UNC0678A better facilitates the relevant objectives than those proposals which contain an NTS Optional Charge.

Please fully justify your response.

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;**

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;**

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);**

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;**

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

As explained above, we consider that the proposed RPM is deficient if it is not accompanied by a cost-reflective NTS Optional Charge.

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?

As mentioned above, we consider that businesses require appropriate notice of major reforms to network charges in order to respond and adjust to them. However, Ofgem is proposing to implement a wholesale change to the charging regime at only a few months' notice, which we do not consider to be best practice. Ofgem's timetable for implementation appears to be driven purely by a desire to demonstrate compliance with the EU Tariff Network Code, which seems premature given the uncertainty about the UK's future energy relationship with the EU following Brexit.

Electricity producers had already entered into capacity market agreements through to September 2022 on the basis of the current gas charging regime and had taken decisions on whether to participate in auctions covering the period through to September 2024 before Ofgem's minded to decision was published. EPUKI therefore considers that implementation of gas charging reform should be delayed until October 2022 at the earliest, although impacts on and responses from users will continue beyond this date.

EPUKI also considers that any gas charging reform solution should contain a shorthaul tariff. If the structure of, eligibility for and discount offered by this shorthaul tariff are to be substantially different compared to today, we consider that changes to the shorthaul tariff should be phased in over a number of years (until October 2024 at the earliest) to allow users of shorthaul sufficient time to respond, including building bypass pipelines where practical.

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?

Please see 'General comments' section above.