# GAS TRANSMISSION CHARGING REGIME

## UNC678/A/B/C/D/E/F/G/H/I/J: minded to decision and draft impact assessment

**Summary**

OGUK is the leading representative organisation for the UK offshore oil and gas industry. Our membership includes around 400 organisations with an interest in the UK's upstream oil and gas sector. As the champions of industry, we work on behalf of the sector and our members to inform understanding with facts and evidence, engage on a range of key issues and support the broader value of this industry in a changing energy landscape.

Although we have a range of members with different commercial positions and interests, there is a general view within the OGUK membership that a postage stamp charging structure is now the most suitable reference price methodology for the UK gas transmission networks.

There is also general support for a timely decision (i.e. October 2020) by Ofgem although ideally this should be subject to addressing the shorthaul question adequately. OGUK members support the need for a well-designed and targeted shorthaul discount, which reduces the level of bypass risk without providing additional subsidy to supplement to 0678A (see response to Question 9).

Our response to the Panel consultation in May 2019 explained a number of these points in more detail and is included as an Annex. The answers to the questions below refer to the May 2019 document as appropriate, while adding or commenting on any new evidence that has emerged since then, including the Ofgem impact assessment.

**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?**

Please see Annex A which sets out OGUK response to the UNC Panel May 2019 consultation which agrees with Ofgem's assessment as to the merits of postage stamp as a more appropriate RPM as follows.

- It better reflects the actual cost drivers of transportation from entry to exit of the transmission system in that future costs drivers are largely non-locational.
- It avoids price distortions at entry and exit points which are at the extremities of the network,
- Charges will be more stable and predictable.
- The methodology is easier to understand and simpler to implement, particularly for the Forecast Contracted Capacity (FCC) element which can be more easily incorporated into the UNC Code itself

OGUK would note that since May 2019, NGGT has published its draft Business Plan for the RIIO2 period 2021-26. As well as highlighting the increasingly overall variability of the direction of flows on the gas networks NGGT's proposals for totex do not appear to have strong underlying locational drivers.

Given this point and the fact that, as Ofgem notes, "the distances used in the CWD RPM are averaged across all points for the purposes of setting tariffs [and] may not represent real physical flows in a highly meshed network such as the GB gas transmission system", the postage stamp methodology is more cost reflective than CWD.

With respect to other remaining elements of Ofgem's principles-based analysis, OGUK would agree that PS also outperforms the CWD as a reference price methodology in terms of avoiding undue discrimination, promotion of competition and security of supply in that it does not discourage flows at more distant entry and exit points. Meanwhile in terms consumer and environmental impact and potential risk of network bypass there appears to be limited difference between the two potential RPMs. Therefor overall, OGUK agrees that the Postage Stamp is a more appropriate RPM in light of the circumstances of the GB network.

**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?**

This point was also covered in our May 2019 response to the UNC Panel (see Annex A). Including the FCC into the UNC itself is preferable and also simpler and more predictable under the PS methodology.

**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?**

OGUK members are currently participating in a number of CCUS and Hydrogen cluster projects located across the UK. All these projects will need to progress at scale in order to contribute to the UK government net zero objective. A postage stamp tariff is a more predictable and simpler framework for these nascent technologies and therefore preferable.

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

The quantitative analysis covers a 10-year period during which there are many uncertainties across energy market drivers. As Ofgem notes in Section 5.4, any forward-looking analysis for such a period can only ever be indicative. Many assumptions have been made with respect to e.g. shipper and supplier behaviour while other important drivers are beyond the scope of the modelling carried out.

Generally speaking, under the status quo (SQ), revenues are largely collected from a commodity-based charge so this can be expected to feed through directly into wholesale gas prices. Whereas the new charging structure, being largely capacity based will have more indirect and dynamic effects that are more difficult to model in terms of wholesale market impact.

It would appear, however, that the modelling indicates a lower wholesale price will tend to result under any of the capacity-based methodologies, with higher consumer welfare compared to the status quo. The modelling thus implies a reallocation of costs from producers/shippers to consumers under both CWD and PS capacity-based charges with a broadly similar effect. This result appears intuitively reasonable although much will then depend on how producers, shippers and the retail markets then respond to a marginal reduction in wholesale gas prices.

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

Please see response to Q1 and Annex A. As discussed, the code modification based on postage stamp as RPM outperforms CWD and the status quo (SQ) against the code objectives in that these:

- are more consistent with efficient and economic operation of the pipeline system and better takes account of developments in the transportation business;
- promote coordinated, economic and efficient operation of combined pipeline system;
- are more reflective of the costs incurred by the licensee;
- promote effective competition by reducing variability and increasing predictability of transportation tariffs
- promote security of supply by treating all sources of gas on an equal basis.
- allow for FCC to be more easily incorporated into the cost promoting an efficient process.

**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.**

OGUK notes Ofgem's evaluation of the compliance of each of the alternates with the requirements of the TAR code.

**Question 7: 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?**

Please see response to Question 1 and Annex A.

**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 is a simpler and more predictable methodology which will enable network users to calculate and forecast reference prices. The ability to more simply incorporate the FCC approach into the charging methodology is a particular advantage of PS in this regard.

*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;*

NGGT's Business Plan submission clearly reflects the situation of a meshed network with considerable spare capacity. Although flows are declining the aggregate capability of the network to reliability cope with a range of different flow patterns and different market and network circumstance is now the most important cost driver which is driven by the multiplicity of network users on an equal basis.

*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);*

PS better avoids discrimination and cross subsidy particularly to the extent that it does not, unlike CWD, unduly discourage flows at more distant entry and exit points. The illustrative CAA calculations submitted by NGGT clearly

show a more even cost allocation between different entry and exit points under the proposed RPM based on postage stamp. [Table A.4 - CAA].

*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 discussed in the response to Question 4 above, the impact assessment suggests some degree of transfer of volume risk away from final customers resulting in a small reduction in wholesale gas prices. Although this will eventually depend on the interactions of market participants in wholesale and retail markets there is no evidence to suggest that the recommended RPM will assign volume risk to final consumers than other compliant charging methodologies.

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

The proposed RPM does not contain any specific features that would adversely affect cross border trade. In this regard, it is notable that most EU Member States have chosen to use a postalised system of charges[1] and that only three have, so far, opted to use CWD. Of these Member States, all three have a chosen an entry/exit split which allocates a lower than 50% share to Entry. So, it is possible that using CWD with a 50:50 split would unduly penalise UK producers and potentially distort competition across the EU.

**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?**

OGUK supports the objective of a timely decision which would enable implementation of the new tariff regime by October 2020. However, the new charging scheme should look to provide a solution to preventing the risk of an inefficient by-pass of the National Transmission System (NTS) by large sites in proximity to NTS entry terminals. It is particularly important that a basic form of an Optional Charge, which will protect the risk of zero-kilometre distance by-passes, is delivered in time to be incorporated in the new capacity tariff that is planned to apply from 1 October 2020. This basic Optional Charge can then be refined after the new charging regime is implemented.

**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?**

No

**OGUK**
**February 2020**

[1] See IOGP analysis in Annex

**ANNEX: SUMMARY OF OGUK MAY 2019 RESPONSE TO UNC PANEL CONSULTATION**

**About Oil and Gas UK**

Oil & Gas UK is the leading representative organisation for the UK offshore oil and gas industry. Its membership comprises the main oil and gas production business in the UKCS and around 300 contractor companies right across the UK. The submission below provides further explanation of Oil and Gas UK position on the 0678 modification and the individual alternates.

**Ofgem response to 0621**

In its letter of 20 December 2018 Ofgem set out its view that neither modification 0621 nor any of the alternate modification proposals were consistent with the TAR network code. Ofgem's decision highlighted a number of key points with respect to compliance with the which are, as a consequence, not discussed in this response.

- The use of Obligated Capacity as a basis for the calculation of tariffs was judged by Ofgem as not consistent with the TAR Code which requires the reference methodology to be based on forecast contracted capacity (FCC). Ofgem noted that OC would be a poor proxy for FCC based on current and expected future use of the network. Ofgem also rejected the concept of a transition period which it noted was not provided for in the TAR code.
- The retention of a commodity charge for the purposes of revenue recovery was considered as unlikely to be consistent with the TAR code especially given the scale of likely under recovery using the OC values. The TAR code only allows for commodity-based charges "as an exception". Likewise, the possibility of a commodity based optional short haul charge was also evaluated as inconsistent with the TAR network code.
- Ofgem considered that Article 35 could provide certainty and protection for historical bookings made before the entry into force of the TAR Code (6 April 2017) but would not apply to any so-called "interim" contracts" entered into between that date and the implementation in the UK.

Ofgem's decision letter contained the implicit requirement for industry to recommence a modification process that would deliver compliance with the TAR code. This led to Modification 0678 that was raised by National Grid on 17 January 2019 and was granted "urgent" status by Ofgem on 25 January 2019.

**Remaining Issues for Oil and Gas UK members in 0678**

National Grid Gas ("NGG") as transmission system operator has put forward Modification 0678 following Ofgem's decision and there are 10 alternates. The differences between these alternates can be summarised under five main topics.

**a. Application of CWD versus postalised charges**

Capacity Weighted Distance ("CWD") is noted in the TAR as a suitable reference methodology although there is flexibility to use alternative reference methodologies such as postalised charges. Under CWD the weighted average distance for each entry point (or cluster of entry points) to each exit point (or cluster of exit points) is determined using a distance matrix. The rationale for CWD is that it moves away from the largely obsolete LRMC based system currently in place while still retaining a distance related element that looks to represent the costs implied by different users of the network.

The argument for maintaining some form of locational signal could be appropriate to the extent that it was thought that:

a) congestion or other costs such as maintenance can be avoided in future; and
a. businesses are able to respond to a stable methodology in deciding which entry and exit points to use.

The general view among Oil and Gas UK members is that these arguments are less convincing given the lack of systematic congestion on the network, and the limited scope for some network users to respond to locational signals.

The main alternative, put forward in a number of the alternates, is to move to postalised charges where all entry and all exit points pay the same capacity-based charge. To some extent this reflects the outcome of the current charging regime since many participants have, over time, increasingly taken advantage of the possibility to book interruptible capacity at zero capacity charge. This has led to the bulk of transmission revenue being collected via a postalised commodity charge.

The main rationale for a postalised scheme is the increasingly uncertainty which points to there no longer being a predictable and prevailing flow of gas in the network. Indeed, the main elements of expenditure expected during RIIO2 are to support overall flexibility and capability of the network *as a whole*.

Likewise, another important feature from a consumers' perspective is the capability of the national network to deliver security of supply in more extreme conditions as evidenced by the experiences during winter 2017-18. In this context, it can be argued that a postalised methodology better supports competition, in the interests of consumers, since it provides equal access to the "virtual balancing point" and avoids giving disadvantages to particular sources of gas which, eventually, may result in less diverse sources of supply.

A final case for postalisation is that shippers using peripheral entry points such as St Fergus are unlikely to be able to respond easily to shift production which will be based on long term investment in UKCS. Distance related charges are therefore inconsistent with other government objectives such as MERUK as higher charges at UKCS entry points will make MERUK more difficult to deliver. In this regard, it is notable that most EU Member States have chosen to use a postalised system of charges[2] and that only three have, so far, opted to use CWD. Of these Member States, all three have a chosen an entry/exit split which allocates a lower than 50% share to Entry. So, it is possible that using CWD with a 50:50 split would unduly penalise UK producers and potentially distort competition across the EU.

***Overall, the case for using CWD as a reference methodology is not particularly strong with the risk of reducing and distorting competition to the detriment of consumers and damaging other policy objectives such as MERUK. Oil and Gas UK therefore favours postalised charges.***

[2] See IOGP analysis in Annex

**b. Discounts for storage and interconnectors etc.**

The TAR network code already requires a 50% discount to be given at charging points relating to storage facilities. The rationale for this is that without the discount users will potentially be obliged to pay for exit and entry at the site of the storage facility and that this is not cost reflective. Further analysis of the charges being paid by users of storage, particularly in the UK context have been made to justify a larger discount of 80% as reflected in alternates C, E and F.

***Oil and Gas UK would generally not favour modifications or alternates that go beyond the minimum discounts required by the TAR code unless a clear case can be made on a cost-reflectivity basis. As a general principle, all sources of gas should face the same charging structure.***

**c. Revenue Recovery from Existing Contracts**

Many network users have longer term bookings as part of their commercial strategies and in line with the prevailing regulatory regime. These are discussed in the Network Code, Article 35, with a requirement that "this Regulation shall not affect the levels of transmission tariffs resulting from contracts or capacity bookings concluded before 6 April 2017 where such contracts or capacity bookings foresee no change in the levels of the capacity- and/or commodity-based transmission tariffs." A number of Oil and Gas UK members consider that this would rule out any application of the capacity-based adjustment to charges to deal with revenue recovery. This is reflected in 0678 and alternates 0678A, B, D, I and J.

Meanwhile 0678C, E, F, G and H would treat existing and new contracts in a similar way with only capacity at storage connection points being exempt from revenue recovery. The rationale for this is that exemption of existing contracts would treat holders of capacity unduly favourably compared with new bookings. Some companies highlight the potentially very large differentials between charges for providing the same service at certain entry and exit points that may arise. They argue that this regime better reflects the code objectives with respect to, for example, competition.

***Oil and Gas UK does not have a collective view on this topic which will largely come down to a question of legal interpretation of the TAR NC.***

**d. Optional short haul tariff**

The shorthaul tariff is currently available to all users and was originally designed as an incentive to avoid inefficient investment in dedicated pipelines where the associated flow would bypass the NTS. Upon requesting the OCC an entry/exit site specific rate is calculated by NGG providing an alternative charge to NTS entry/exit TO and SO commodity charges. Over time the calculation parameters have not been updated and the shorthaul tariff is increasingly attractive, even for relatively long distances.

The NGC proposal does not include a short haul arrangement although a separate workgroup process (0670R) is currently underway to review the arrangements. By contrast, Alternates 0678B, D, E, H and J all contain some form of capacity based optional charge. Meanwhile 0678I proposing a point-to-point "wheeling" tariff for gas transiting across the UK into the neighbouring Irish market.

The optional short haul tariff is designed to avoid a situation where network users have the incentive to by-pass the transmission system by building a separate connection to the entry point. This could potentially lead to the undermining the integrity of the network and the NBP as a liquid wholesale market. Oil and Gas UK Members

continue to view some form of shorthaul arrangements as necessary particularly if a CWD based methodology is adopted which will exaggerate the incentives for bypassing the national network.

***Oil and Gas UK supports the continued use of a short haul element to tariffs but opposes the concept of a "wheeling charge".***

**e. Forecast Contracted Capacity ("FCC")**

Following Ofgem's decision, NGC have developed a methodology for calculating FCC based on existing bookings and historical flows to make a projection of contracted capacity in the following year. NGC propose that the FCC methodology is not included in the UNC Code itself, rather that it is review or updated by National Grid following consultation with stakeholders, unless Ofgem specifically intervenes. Other alternates such as 0678C and 0678J propose that FCC is included in the UNC with the normal oversight from the Industry Group to govern any changes.

The main argument for not including FCC is that NGC expect to make iterative changes to reflect experience with the new methodology. However, on balance most Oil and Gas UK members would prefer the FCC methodology to be part of the code since changes are likely to have a material and differential impact on tariffs. In this regard, it is notable that, under CWD, the FCC methodology requires a forecast to be made at every entry and exit point. This make inaccuracies and distributional effects more likely. By contrast, postalised charging would give a simpler task to NGC in forecasting total amounts of capacity to be booked and make changes to FCC less impact on individual businesses and potentially justify a simpler governance process.

***Oil and Gas UK would prefer the FCC to be included in the UNC.***

**Oil and Gas UK**
**May 2019**

**Summary of Reference Price Methodologies by EU Member State**

| | Country/system | Poposed method | Entry/exit-split |
|---|---|---|---|
| 1 | Netherlands | postage stamp | 50/50 ? |
| 2 | Sweden | postage stamp | 0/100 |
| 3 | Northern Ireland | postage stamp | output |
| 4 | Romania | postage stamp | 50/50 |
| 5 | Denmark | postage stamp | output |
| 6 | Portugal | modified CWD | 40/60 |
| 7 | Slovenia | matrix | 16/84 |
| 8 | Poland | postage stamp | 50/50 |
| 9 | Poland TGPS transit | capacity weighted distance (CWD) | 51.5/48.5 |
| 10 | IUK | other | |
| 11 | Belgium | CWD | 33/67 |
| 12 | Greece | postage stamp | 50/50 |
| 13 | Germany | postage stamp | 38/62 & 32/68 |
| 14 | Italy | CWD | 28/72 |
| 15 | Czech Republic | CWD | 20.35/79.65 |
| 16 | Slovakia | postage stamp | 50/50 |
| 17 | Hungary | postage stamp | 40/60 |
| 18 | Ireland | matrix | 33/67 |
| 19 | Croatia | postage stamp | 60/40 |
| 20 | Great Britain | | |
| 21 | Austria | virtual point-based | 20/80 |
| 22 | Lithuania | postage stamp / transit | 70/30 |
| 23 | BBL | other | - |