

UNC728/A/B/C/D

“Introduction of a Conditional Discount for Avoiding Inefficient Bypass of the NTS”:

minded to decision and impact assessment

Consultation response

Overview

The distortions associated with an overly generous shorthaul tariff that created cross-subsidies in gas transmission tariffs of around £150m per annum were removed on 1 October 2020.

The GB system now faces a risk of bypass from a very small number of routes. A proportionate shorthaul arrangement may therefore deliver benefit to gas consumers and more widely. However it is vital that discounts are targeted appropriately and are not too generous.

Ofgem’s work carefully considers the issue. It articulates the challenge well and recognises the trade-offs that need to be carefully considered. Crucially Ofgem recognise that assuring all load remains on the system might be inefficient and not in the consumer interest.

This response explores compliance, the evidence base and the technical solution.

The proposals need to be considered in the context of retained EU law and specifically with regard to whether discounts for the standard transportation can be applied. The law reflects a “one price for one service concept” consistent with the non-discrimination principle. Retained EU law implies that different (i.e. non-standard prices) should only apply in limited circumstances and/or in respect of different conditions for firm capacity products (i.e. for a different service).

CEPA’s analysis and methodology provide vital context to the decision. Specifically it urges caution about the interpretation of the analysis given the dependence upon assumptions and the relatively low welfare impact differences derived in respect of any of the UNC728 proposals compared with the status quo. These differences are small and perhaps well within a reasonable error margin given uncertainties and the assumptions.

The most critical assumption is the binary “remain” or “leave” assessment of a very small number of individual routes. No doubt those with most at stake, particularly but not exclusively those that would be directly and immediately advantaged by discounted transportation rates, will respond to the consultation. Such responses may contribute to an Ofgem re-evaluation and the decision could be different from the minded-to position given the sensitivity to so many assumptions.

There remains a significant risk that the proposals on the table are suboptimal. The charging functions advocated have not been properly justified. Eligibility may be far wider than is necessary and so the prospect of undue “wasteful discounts” exists.

Fortunately the major dysfunctionality of shorthaul has been removed. However care should still be taken not to introduce a too generous scheme with adverse consequence to the gas consumer as well as wider detriment.

1. Introduction

Thank-you for the opportunity to respond to the above consultation.

This response has been delivered by Sisman Energy Consultancy Limited. It has not been sponsored. The interests of the domestic and smaller industrial and commercial consumer are often unrepresented in the UNC development and decision making processes. This response might plug that gap in respect of this proposal¹.

It is encouraging that Ofgem has carefully considered the key issues in its Impact Assessment that had not been considered prior to the raising of, and pre-consultation discussions associated with, the UNC728 modifications last year.

It is impossible to fully scrutinise the underlying models and evidence that has supported Ofgem's minded-to position. Ultimately it will be for Ofgem to decide in respect of the UNC728 Modifications before it. The final decision will depend critically upon Ofgem's assessment about whether load will remain, or leave, the system under the status quo and each of UNC728/A/B/C/D.

The shorthaul tariff was one of the largest distorting factors in our pricing regime² and great care needs to be taken about any reintroduction. The risk of some bypass is likely real. A carefully constructed and proportionate scheme is necessary to secure a good outcome. The implementation needs to fairly balance the interests of those that might, justifiably, receive preferential discounts to those that otherwise would bypass and those that will have to pay the consequential prices arising because of those discounts. It is vital that sufficiently large discounts to retain all load are not offered unless proven as optimal; wasteful discounts will inflate prices to the detriment of consumers. Furthermore it is essential that Ofgem's decision takes account of wider impacts beyond gas consumers.

The rest of this paper provides some comments about the methodology. It addresses the specific questions Ofgem pose for consultation. It also provides some final closing remarks including relating to some more general matters.

We hope this input will assist Ofgem and remain available to discuss any aspect of this response.

2. Commentary on Ofgem's methodology

We are encouraged that Ofgem's work since it received the UNC728 Modifications from Panel has been focussed on the important issues of compliance, assessment of individual route bypass risks and the avoidance of excessive and wasteful discounts.

These were issues that were not adequately addressed in the formulation and development of the UNC728 proposals. The approach reflecting assessment of both first and second order effects provides an important advance on the earlier work in the area.

¹ For example we considered it necessary to submit a response to the UNC0728 consultation:

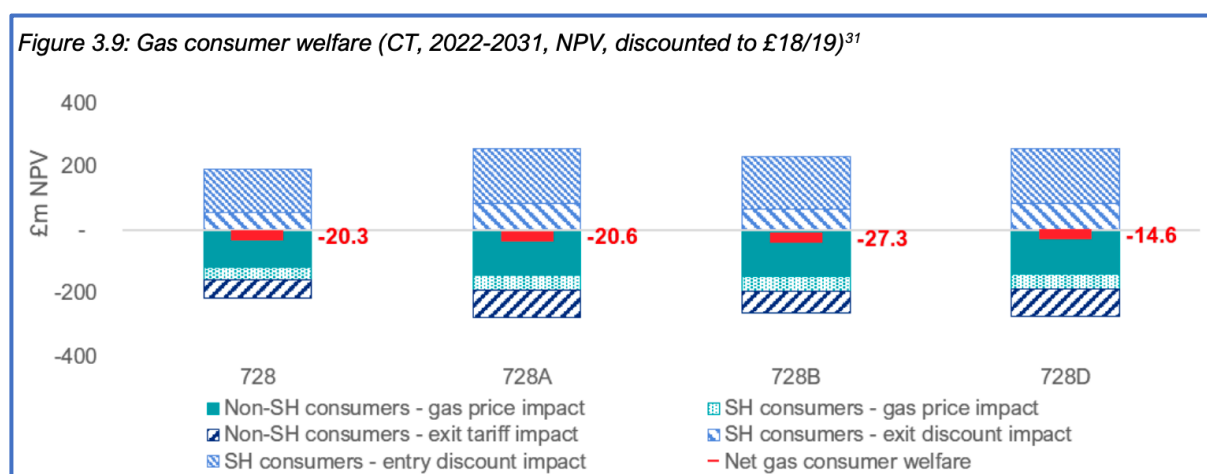
<https://www.gasgovernance.co.uk/sites/default/files/ggf/book/2020-06/Representation%20-%20Sisman%20Energy%20Consultancy%20Limited%20Paper%200728ABCD.pdf>

² The pre-October 2020 pricing regime suffered three major weaknesses: an excessively generous shorthaul tariff, zero reserve prices and inadequate price relativity of longer and shorter term capacity (the absence of multipliers). UNC678A addressed the first two although resolution of the third remains outstanding.

We acknowledge, however, that whilst the methodology is quantitative the results, and hence the final decision upon UNC728/A/B/C/D, will be highly dependent upon critical judgements in respect of the risk of bypass³ at individual route level.

Additionally the analysis is assumption based and some of those assumptions may affect the outcomes. For example, the CEPA analysis notes “we assume that the discounts at both entry and exit are passed through to the eligible offtaker such that the offtaker benefits from a discount at both entry and exit”⁴. It is widely appreciated that this was not the case under the previous shorthaul arrangements where, even most recently, it has only been the exit benefit (or part thereof) that has fed through to the offtaker. This might suggest that the first order consumer welfare detriment should have a larger magnitude than has been factored into the consideration.

The uncertainty here should be appreciated. The following draws on CEPA’s Figure 3.9⁵.



In all four cases the Table 3.9 net gas consumer welfare is negative. The relatively low levels of first order welfare detriment arise because of the assumed benefits arising from pass through of discounts to offtakers on eligible shorthaul routes (SH consumers). Whilst it may be that some of those benefits on exit might be passed through it is far less likely that this will be the case on entry. Thus it is likely a considerable proportion of the “above the line” contributions will not materialise. Therefore the magnitude of welfare detriment (within the range £14.6m to £27.3m) will be understated. This understatement might be of the order of £100m⁶.

Additionally CEPA remark⁷ that “under a scenario in which electricity consumer welfare increases as a result of a lower electricity price, it is possible that some of the benefits may be counterbalanced by higher capacity market costs”.

Thus the first order total welfare detriment may have greater magnitude than indicated. The necessity of making assumptions⁸ is recognised, but these may contribute to an overstatement of the customer

³ In effect the risk is assessed in a binary manner: each individual load will either bypass or remain on the system. Therefore each site will be assessed as either a “remainder” or “leaver” under each of the options and the status quo.

⁴ CEPA UNC728 – Analytical support Final Report Gas market consumer welfare impacts (page 31)
https://www.ofgem.gov.uk/system/files/docs/2021/01/cepa_unc728_analytical_support.pdf

⁵ From CEPA UNC728 – Analytical support Final Report

⁶ We invite the reader to look at the hatched components in CEPA’s Table 3.9 representing SH consumers – entry discount impact to make his/her assessment

⁷ See CEPA report “The electricity market model” section (page 19)

⁸ Indeed we understand that the assumptions made are the “usual ones” because it would be, for example, very difficult to assess what proportion of the exit benefit might be shared between shipper and offtaker

welfare position. This might need to be acknowledged given awareness of the imperfect functioning of both gas and electricity markets. Furthermore, given that overall detriment from first order effects might be larger than those benefits associated with the second order effects⁹ under UNC728/A/B/C/D, the status quo might deliver a better outcome.

CEPA has based its assessment of bypass pipeline costs by adapting a cost function developed by NGGT. A previous response has raised concerns about NGGT's analysis in this area¹⁰. Thus CEPA's refinements improve the assessment. However we still note CEPA's reservations and its indication that "our (CEPA) analysis represents an over-estimate of bypass risk"¹¹.

It is hence appropriate that Ofgem has taken its own view of the risk of bypass and that this is substantially less than the high bypass sensitivity. Further we recognise that the final decision will depend critically upon an assessment of a few route specific costs of the potential competing pipelines¹².

Ofgem's remarks suggest the discounts associated with UNC728D may be too generous. Whilst Ofgem considers that the 28 km cap has a better justification than the 18 km cap the charging function would yield higher discounts than associated with a charging function having the same form as the UNC728 proposal. Thus the 28 km cap might introduce a higher risk of excessive, wasteful discounts than would be associated with the 18 km cap. The charging functions should be better justified. The charging function is, of itself, delinked from potential competing pipeline costs. This may make it harder to justify any of the proposals under UNC728/A/B/C/D.

The short-haul discount must be proportionate to the risk of bypass. It should not aim to eliminate all risk of bypass; such an outcome might be suboptimal.

Ofgem's minded-to position is based on its assessment that 8 routes would be lost in the status quo whereas only 2 routes, albeit different ones, would be lost should either of UNC728B and UNC728D be implemented. The consultation solicits views from those that might be materially affected by the possible outcomes.

From a general consumer's perspective 1 October 2020 saw the removal of the old shorthaul discount that was generating a distortion and associated cross-subsidy of around £150m per annum in gas transportation costs alone. The cross-subsidies envisaged in these proposals are much smaller than have existed and, if Ofgem's assumptions about remainers and leavers are accurate, the cross-subsidies might be considered to be duly discriminatory and to the benefit of the generality of gas consumers.

However the modelling suggests that the identified benefit is very small compared with the variability that might arise from the flexing of some assumptions reflecting likely market outcomes.

There has been no mention of sites bypassing the system¹³ since 1 October 2020 despite being told how easy it would be for some sites to leave, particularly where alternative infrastructure is readily

⁹ As assessed in Section 4 of the CEPA report

¹⁰ See response to UNC728 consultation: <https://www.gasgovernance.co.uk/sites/default/files/ggf/book/2020-06/Representation%20-%20Sisman%20Energy%20Consultancy%20Limited%20Paper%200728ABCD.pdf>

¹¹ See for example CEPA report page 23

¹² Effectively the binary state, "remain" or "leave", will be derived for each eligible route. This will have likely involved the derivation of a price proxy that reflects asset, operational and any other factors for the potential competing pipeline alternative. This will then be compared with standard prices, and those discounted prices available under UNC728B and UNC728D. We also note, and support with regard to this piece of analysis, that CEPA's third order effects from page 40 are ignored

¹³ This simplifies the concept from cross-border perspective where interconnector flows might be highly sensitive to tariff pricing levels

available. It may be that there are other elements of our current framework that have mitigated this risk, or that the challenges of utilising other infrastructure are perhaps greater than suggested? It would appear, assuming the appropriateness of the underlying assumptions in the Impact Assessment, that there is not a lot at stake for the generality of customers and that the status quo would seem to offer little downside for the generality of consumers. Indeed it would seem that the priorities associated with other tariff regime challenges that need to be addressed as a priority might be far greater than this one. Hence if Ofgem feel more time or analysis would be helpful, then we suggest that it indicates so accordingly. From the perspective of the general consumer there is no “burning platform” here; the substantive problem of major distortions and cross subsidies has already been addressed.

We encourage Ofgem to exercise its judgement, having critically assessed all responses to this consultation and in the context of delivering a robust and proportionate scheme that finds the right balance between all consumers reflecting the real likelihood of bypass. This, of course, might necessitate a different solution.

3. Responses to Specific Questions

Question 1: Do you agree with our assessment of the modification options against the applicable UNC objectives?

The following focuses upon UNC728B and UNC728D.

Objective (a) Efficient and economic operation of the pipe-line system and CMRO Objective (b) that, so far as is consistent with sub-paragraph (a), the charging methodology properly takes account of developments in the transportation business.

The efficient and economic operation of the system will be promoted by decisions that seek to maximise throughputs consistent with appropriate charging arrangements. Thus proposals must address the “wasteful discount” conundrum by optimising between the provision of discounts and the retention of loads on the system. All of the options seek to do this although, of course, a sound assessment critically depends upon the assumptions and modelling used.

Ofgem have a particular concern about the arbitrary 18km distance threshold used in some of the proposals. However the two preferred approaches also feature distance thresholds that might not have been fully justified. It might be preferable if the charging function had been constructed so that it yielded prices that might have been consistent with the costs of building a dedicated pipeline. It would seem that the discount functions have not been sufficiently justified. For example in the case of UNC728B by selection of two points on a “negative exponential” function passing through (0,90), and (28,10)¹⁴. There is no justification as to how this function might compare with potential competing pipeline costs over a range of 0 to 28km. Similarly the UNC728D function might be regarded as unjustified, other than perhaps as sufficient to retain all load at less than 5km distance. However its optimality has never been justified in the context of “wasteful discounts”.

On the assumption of the robustness of all input assumptions and particularly the assessment of which loads will bypass under each of UNC728B or UNC728D both these options would further these relevant objectives.

¹⁴ The form of the charging function has never been justified. (x,y) correspond to (distance(km), % of relevant charge)

However Ofgem appear to have some reservations about both UNC0728B and UNC0728D in the context of these objectives. We concur that there is a risk that both might confer too generous a discount on some loads and that therefore either of these proposals might be suboptimal.

Objective (c) Efficient discharge of the licensees' obligations and CMRO Objective (a) save in so far as paragraphs (aa) or (d) apply, that compliance with the charging methodology results in charges which reflect the costs incurred by the licensee in its transportation business

The current methodology introduced under UNC678A must be considered to result in charges which reflect costs incurred by the licensee. Hence the introduction of any discount could be assessed as detrimental to these objectives.

However the introduction of discounts might further other objectives. Those other objectives should have greater weight in Ofgem's assessment.

Objective (d) Securing of effective competition and CMRO Objective (c) that, as far as is consistent with sub-paragraphs (a) and (b), compliance with the charging methodology facilitates effective competition between gas shippers and between gas suppliers, and CMRO Objective (aa) that, in so far as prices in respect of transportation arrangements are established by auction, either: (i) no reserve price is applied, or (ii) that reserve price is set at a level: (I) best calculated to promote efficiency and avoid undue preference in the supply of transportation services; and (II) best calculated to promote competition between gas suppliers and between gas shippers.

Prices should be set at levels that minimise distortions. It is therefore critical that tariff arrangements should seek to minimise the extent of discounts offered to ensure consistency with minimising the average cost of transportation for all those that remain on the system.

However a concern arises because historical discounts have not passed through to consumers with consequential distortion of competition.

We concur with Ofgem's views that neither UNC728B nor UNC728D delivers a favourable impact on these relevant objectives.

Objective (g) Compliance with the Regulation and any relevant legally binding decisions of the European Commission and/or the Agency for the Cooperation of Energy Regulators and CMRO Objective (e) compliance with the Regulation and any relevant legally binding decisions of the European Commission and/or the Agency for the Cooperation of Energy Regulators

The law requires¹⁵ that the standard products shall be charged at the relevant reference price save for explicit adjustments permitted¹⁶. We understand that whilst UNC728B and UNC728D confer discounts the relevant User receives the standard transportation service albeit with the reduced price being contingent on flows.

We note that benchmarked tariffs are permitted under Article 6(4)(a) of TAR NC and specifically that a German example has been referenced.

In assessing the German example it is important to recognise:

¹⁵ Commission Regulation (EU) 2017/460 Article 6

¹⁶ Article 6 Clause 4 envisages discounts for Storage and LNG, and for benchmarking, common pricing to homogenous group of points or for scaling.

- the two routes cited involve an IP, and either a storage facility or a large industrial site
- the tariffs have been set by explicit reference to anticipated potential costs of competing pipelines
- those potential competing pipelines would introduce new, potentially inefficient investment to connect the Austrian grid directly with the storage facility and the industrial site
- the discounted tariffs cannot be used to move gas between Austria and Germany (or vice versa) via the storage facility unless standard charges apply to the cross-border transfer, and crucially¹⁷
- the service involves a separate balancing account for the use of this part of the German network.

This case is regarded very much as a special case in Germany. Access to the relevant prices is solely via a separate balancing account that can only involve the 3 relevant points. This effectively defines a balancing zone that is independent of the Net Connect Germany (NCG) area and precludes access to the NCG virtual trading point. This is rather different to the current GB proposal where the discounted price is offered in respect of flows associated with the standard network access service and with normal portfolio balancing and access to the NBP.

Therefore it is not clear that the German example provides a direct comparator for GB's proposed, and potentially far more widely available, option¹⁸. Additionally, for example, it is doubtful that the resulting prices for NTS transmission service would accurately reflect the costs of potential competing pipelines over distances of any length up to the 28km straight line distance¹⁹. Additionally the German case involves separate balancing accounts and so the beneficiaries of those services are purchasing a different service to that which is available to other flows in the German network.

Furthermore our understanding of the intent of the legislation is that the discounts offered to avoid bypass should be the minimum possible and, based on current EU precedent and ACER opinion, might only be appropriate with transports associated with IPs²⁰.

These factors may cast doubt about the appropriateness of UNC728B and UNC728D, particularly in respect of application at non-IPs.

Objective (f) Promotion of efficiency in the implementation and administration of the code

Whilst the impacts here are likely to be small the calculation of the pricing discount is explicitly defined by a formula. The form and parameters of the charging function may not have been adequately justified.

It is therefore not clear that the proposals improve efficiency of implementation and will complicate administration by introducing more complicated tariff arrangements.

The industry should learn lessons from our earlier experience of shorthaul discounts and that, if implemented, the charging function should be occasionally reviewed to ensure that it is revised,

¹⁷ Thus the service is not the normal access that applies to the NCG balancing zone

¹⁸ The envisaged tariff would be available to 32 routes under UNC728B and 22 under UNC728D

¹⁹ The German shorthaul pricing is based on anticipated prices of specific pipelines, one for each route, with corresponding different prices for the entry/exit combination

²⁰ UNC728 modifications imply wide eligibility, with up to 32 different eligible routes, which seems rather different to the very small number of limited "benchmark" examples elsewhere in Europe. It is unclear why the GB situation should be so different.

where appropriate, to ensure its efficacy. The proposals do not advocate any such review which is unfortunate and perhaps another shortcoming.

Question 2: What are your views on our conclusion that the proposed modification proposals constitute a “benchmarking” adjustment to the application of the reference price methodology (Article 6(4) TAR NC)?

This has been considered against RO (g) and CMRO (e).

Thus the proposals might not be considered a “benchmarking” adjustment comparable with other European precedents. The German case recognises TAR NC Article 4.2 which states “Transmission tariffs may be set in a manner as to take into account the conditions for firm capacity products.” Crucially the German case recognises that the “benchmarking tariff” must be associated with direct access conditions other than the standard terms. This is reflected in the motivated decision on German tariffs (BK9-19/610) which stipulates for both eligible routes “If the reduced tariff is applied, firm or interruptible access to the virtual trading point must be ruled out. In the event that capacity products with access to the virtual trading point are offered at these points, general tariff structures apply, not benchmarking, if access to the virtual trading point is used within the duration of the capacity.”

It seems discounted prices should only apply to lesser services than the standard transportation service.

Question 3: Do you agree with our assessment of the quantitative analysis?

Yes.

However the assessment depends critically on key assumptions. Most notably the assessment about whether loads will remain on the system under the status quo and against the different discounted price options. Furthermore the assumption that the benefits of the discounts passing through to the relevant customer might not be achieved is important. This is based on experience of our earlier shorthaul experience. Indeed it is widely appreciated that it is only recently during the history of GB shorthaul that the exit charge benefits, or part thereof, have accrued to the consumer.

Hence, should a discounted tariff be reintroduced, enhanced transparency arrangements should be introduced so that those consumers being served via the discounted rates might be aware of that fact.

Question 4: Do you agree with our assessment that UNC728C is discriminatory because of the risk that the discount may be used for a route other than a qualifying nominated route?

Yes.

Question 5: Do you agree with our assessment of the modification options against our statutory duties?

Ofgem's efforts to get beyond the first order effects and consider the second order ones so that it can make a robust decision consistent with its statutory obligations are appreciated. Its final assessment should take account of feedback provided in this consultation process which might change the final decision.

Question 6: Do you agree with our minded to decision to approve UNC728B?

Based on the input assumptions and calculations UNC728B can be viewed as the most favourable outcome. Ofgem's position may, however, change in the light of evidence and feedback arising from this consultation.

Most responses will come from those having significant value at risk depending on the outcome. These responses should inform the final decision.

Whilst those loads directly impacted by the shorthaul eligibility and available discount will be able to assess implications for their gas supply and business²¹ that is not the case for the generality of gas consumers. This response identifies concerns but cannot quantify the impacts of some key assumptions on the generality of customers without knowing the "at-risk" routes, their distances and estimates of relevant volumes.

There could be better solutions to this challenge but the process requires, at this stage, a decision between rejecting all proposals or accepting one of them. However if the responses suggest an alternative better approach then Ofgem should reject these proposals and encourage, or if possible, direct an alternative.

Whilst UNC728B would represent a major improvement compared with the shorthaul discount that existed until September 2020 it may remain unclear whether it offers an improvement over the status quo. From the general consumer perspective all proposals appear to provide substantial discounts to some users for whom it might not be economically viable to bypass.

Question 7: What are your views on our minded-to decision that implementation of UNC728B should take place from 1 October 2021?

Whilst some at-risk users will be experiencing normal transportation charges during this Gas Year tariff price changes should only occur once a year, and at the start of the Gas Year²².

A timely decision is encouraged before the transmission and non-transmission prices are set for Gas Year 21/22. However if Ofgem need more time to evaluate feedback and make a decision, or perhaps arrange an alternative solution, then this should be supported. The analysis in the CEPA report would suggest that the pricing impacts on all but a few actors are smaller than some of the other issues we have faced, and are continuing to address, in the tariff arena.

²¹ The extent of any discount and whether a load is eligible or not will define the differential impacts between status quo and each of the UNC728 options from that routes perspective. The secondary effects to others are likely to be much smaller and so responses will be likely concentrated on those associated with the potential 32 eligible routes.

²² This is understood to be the intent of the relevant retained EU law.

Consumers have suffered from an inappropriate shorthaul for many years. Now that the major dysfunctionality has been removed care should be taken to ensure a robust and sustainable refinement to address the small, but genuine, risk of bypass.

Question 8: 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 determination?

It would be appropriate that, should a shorthaul discount be re-introduced, transparency provisions are enhanced so that, at least as a minimum, those routes availing of the service are made public.

Should Ofgem find itself unable to accept any of UNC728/A/B/C/D then alternative approaches should be considered, perhaps with the matter subsequently returned for industry development. For example a new longer term service could be contemplated. This could involve multi-year booking which might be consistent with the commitments associated with building a pipeline rather than simply receiving cheap on-demand service without multi-year user commitment. Alternatively access to the discounted price could be associated with dedicated capacity bookings and balancing arrangements associated with each route²³.

4. Concluding remarks

It took around 5 years to address the major distortion caused by shorthaul via its removal. That delay suggests a significant governance failure. We believe that the governance of tariff matters should be reviewed. We also note the recent problems with, and volatility of, transmission tariff matters which again question the efficacy of the UNC processes in the tariff arena. These tariff matters have had detrimental impacts on consumers and market functioning. We believe there might be better governance frameworks that should be considered for tariff matters.

Legal assessment of proposals is a tricky issue and needs careful attention. We believe that the industry has poorly scrutinised tariff developments from a legal perspective. An appropriate assessment needs to reflect more than a review and interpretation of specific clauses in the legislation, particularly in the area of retained EU law²⁴. This law is difficult to understand and needs to be assessed in the context of its historical evolution and its policy aims; it is easy to mis-interpret the individual clauses of the TAR NC if the wider legal landscape is not appreciated.

The gas market is changing and going forward new paradigms may need to be adopted. Whilst cost-reflectivity has been a key objective of the tariff framework there has been little consensus about what this might mean. Perhaps going forward, particularly as gas utilisation decreases, we will need to think about the nature of tariff regime objectives. These objectives might need to evolve to reflect cross-system interactions, the pursuit of economic efficiency and delivery social objectives with all the inherent tensions that these involve.

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19th February 2021

²³ Similar in effect to the German example and therefore reflecting both the benchmarking concept and that price discounts are justified via a different service offering.

²⁴ The interpretation of Regulation (EC) No 715/2009 and its subpart Commission Regulation (EU) 2017/460 are particularly problematic