Making a positive difference for energy consumers

Review of the Fleetwood entry point in gas transmission

Consultation

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Overview:

In November 2016, we announced a review into the price control treatment of National Grid Gas Transmission's entry capacity obligation at Fleetwood.

We are now seeking your views on our proposals for changes to National Grid's funding. We are also seeking your views on the appropriate treatment of National Grid's capacity obligation at Fleetwood.

Context

National Grid Gas Transmission (NGGT) is the owner of the high pressure gas National Transmission System (NTS) in Great Britain. To ensure value for money for consumers, we regulate NGGT through periodic price control reviews that limit its revenues and stipulate outputs that NGGT must deliver for consumers and other users of the NTS.

In our two most recent price control reviews for NGGT, we allowed funding of £277.5 million to deliver pipelines and other network infrastructure upgrades to meet its capacity obligation at the Fleetwood entry point.

At the time we provided these allowances, there was some uncertainty as to whether the capacity would actually be needed. We said that we would keep the situation at Fleetwood under review, and would take appropriate steps to ensure that an economic and efficient outcome is achieved for consumers.

Associated documents

Open letter: Review into the treatment of NGGT's capacity obligation at Fleetwood under the RIIO-T1 price controls

RIIO-T1: Final Proposals for National Grid Electricity Transmission and National Grid Gas – Cost assessment and uncertainty

Executive Summary

In November 2016 we announced a review into the price control treatment of National Grid Gas Transmission's (NGGT's) entry capacity obligation at the Fleetwood entry point to the National Transmission System (NTS). This is in line with what we said at the time of setting the RIIO-T1 price controls.[1]

NGGT has an existing obligation to provide 650 GWh/day of entry capacity at Fleetwood. We made an allowance of £277.5 million[2] to NGGT between 2012 and 2019 to fund a number of pipelines and other network infrastructure upgrades to meet this capacity obligation, based on expenditure forecasts provided by NGGT. NGGT has not reported any expenditure so far against these allowances, and has told us that the planned investment is not expected to be needed over the remainder of the current price control period.

Our review considers the appropriate treatment of the funding provided for the Fleetwood entry point. Because the funding was provided to meet the capacity obligation, we are reviewing the obligation at the same time.

The treatment of Fleetwood funding

We are proposing to remove the £277.5 million in funding now. If we don't, consumers will be funding investment that has not taken place. We have considered an alternative of waiting until the end of the price control (March 2021) to make the adjustment, but this would mean consumers waiting longer to benefit. The possibility that any expenditure would be incurred in the remainder of this price control period is small. To the extent that any expenditure is needed in the future, we would consider funding this as part of future price controls.

The treatment of the capacity obligation at Fleetwood

We consider that there is a risk that the situation at Fleetwood is inconsistent with the user commitment principle. This principle is that the user that triggers new capacity on the NTS commits to pay future charges. The value of these charges is based on the assumed cost of making the capacity available.

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[1] In our RIIO-T1 Final Proposals we said that "[we] will continue to monitor the situation and should circumstances require Ofgem to take action to protect the interests of consumers, we will take the appropriate steps to ensure an economic and efficient outcome is achieved (which might affect the treatment of capacity at Fleetwood). This may have implications for base revenue and represents how we would expect to act in any similar situation, as we will generally consider taking steps in accordance with our principal objective to protect the interests of consumers." Please see the "Cost Assessment and Uncertainty" supporting document to our Final Proposals for the RIIO-T1 price controls, available here.
[2] All allowances in this document are expressed in 2009/10 prices so that they are consistent with the RIIO-T1 final proposals.

The original user commitment at Fleetwood was made by Canatxx, a gas storage developer, in 2006. Subsequent developments have meant that Canatxx lost its right to the capacity, and the financial obligation associated with its user commitment has been removed. However, NGGT continues to have an obligation to offer the capacity at Fleetwood for sale at auctions. Only a small amount of capacity at Fleetwood has been purchased so far[3], and it is unlikely that this sale would trigger investment in the network. However, if there are further purchases of capacity at Fleetwood in future auctions, the need for investment might change, leading to consumers' liabilities being higher than they would be otherwise.

We have considered three options for the treatment of the capacity obligation.

Option 1: Do nothing now.

Option 2: Remove the capacity obligation at Fleetwood now.

Option 3: Amend the capacity obligation at Fleetwood to reduce the level of obligated entry capacity (eg to 350 GWh/day, which reflects the amount purchased for one quarter in 2025).

We think the choice between the three options is finely balanced.

Option 1 is the least disruptive, but consumers are exposed to the risk of paying for network investment if the capacity is eventually used. Option 3 partially mitigates this risk by reducing the amount of obligated capacity, and therefore lowers the need for network investment relative to the status quo. However, by lowering the obligation to the level already purchased by one shipper at auction, this option could be seen as giving preferential treatment to that shipper.

Our initial thinking is that Option 2, removing the capacity obligation, would be fairer and best protect the interests of consumers. Under this option any user requiring entry capacity at Fleetwood would need to make a fresh user commitment linked to the assumed cost of network investment. This means that consumers' exposure to these costs would be limited.

However, we are still considering the options and welcome the views of respondents before we reach a final position.

Next steps

We welcome your views on the issues raised by 26 May 2017. We expect to make a decision on Fleetwood in summer 2017. Any changes to NGGT's revenues would take effect on 1 April 2018.

[3] In March 2016, a shipper bought 350GWh/day at Fleetwood for use in one quarter in 2025.

1. How the Fleetwood issue arose, and our proposed treatment of funding

Chapter summary

This chapter provides relevant background to the situation at Fleetwood and sets out our proposals for changes to NGGT's funding.

Question 1: Do you have any views on our proposal to 'true up' NGGT's funding for Fleetwood now?

How the issue arose

Creation of the capacity

1.1. In 2006, Canatxx Shipping Limited (Canatxx), a developer, bid for entry capacity of 650 GWh/day at Fleetwood for a new gas storage facility planned for Preesall, Lancashire. At the time, NGGT was not obliged to offer entry capacity at Fleetwood and a new entry point had to be created in order to meet Canatxx's requirement. Figure 1 explains at a basic level the commercial and regulatory arrangements for creating capacity on the NTS.

Figure 1 Overview of the NTS entry capacity mechanism

Gas can enter the NTS at a number of entry points across the network. NGGT's licence specifies the locations of entry points and the amounts of entry capacity that must be provided at each point.

Licenced gas shippers must buy entry capacity rights before they can inject gas into the NTS (eg from an import terminal or a storage facility). NGGT sells entry capacity in line with its licence obligations at periodic auctions ranging from short term (within-day) to long term (up to 16 years ahead).

Shippers that acquire entry capacity at auction must pay entry capacity charges to NGGT in line with their successful bids. Revenue from these charges counts towards NGGT's annual revenue limits set by us as part of our price control decisions.

Users can trigger the release of new entry capacity by making a user commitment. This involves committing to pay entry capacity charges (over eight years, in net present value terms) that exceed 50 per cent of the assumed cost of investment required on the NTS to create that capacity.[4] When this happens, we add the new capacity to NGGT's licence as a new obligation.

The commercial terms of the sale of entry capacity are governed by the Uniform Network Code (UNC). All gas transporters and shippers must comply with the UNC.[5] Under the code, NGGT must either accept flows of gas into the NTS in line with sold capacity rights or make constraint payments (linked to the wholesale price of gas) to rights holders instead.

1.2. Canatxx's bid passed the user commitment threshold and in 2007 we approved the release of entry capacity of 650 GWh/day, and included it in NGGT's licence. Canatxx acquired the right to use the entire capacity at Fleetwood for the duration of its user commitment. After that, the capacity would have been available to all users at auction.

1.3. Canatxx failed to receive planning permission for its storage site and defaulted on its credit obligations when they fell due in 2009. As a direct consequence of its default, Canatxx lost its right to entry capacity at Fleetwood as well as its obligations to make future payments for capacity.

1.4. NGGT had carried out preparatory work so that it could meet its capacity obligation, reporting expenditure of £9 million until 2010 on technical studies and other desktop work. NGGT halted work when it became clear that Canatxx had defaulted on its payment obligation. No physical infrastructure has been built and no expenditure has been reported since 2010.

1.5. The capacity obligation at Fleetwood was not removed from NGGT's licence and NGGT has been offering the entry capacity for sale at auction since 2013. In March 2016, a shipper bought 350 GWh/day at Fleetwood for use in one quarter in 2025. No other purchases have been made at Fleetwood to date.

NGGT's revenues

1.6. We have allowed a total of £277.5 million in funding in the TPCR4 rollover year[6] and RIIO-T1[7] price controls (on the basis of expenditure forecasts provided by NGGT) to provide the entry capacity (eg to build new pipelines or otherwise modify the network).[8,9] While this funding was allowed at the outset of these price controls,

[4] The assumed cost of investment, or the "estimated project value", is determined by NGGT in accordance with the Uniform Network Code, Transportation Principal Document Section Y, Part A1. For further details please see NGGT's Entry Capacity Release Methodology Statement, published on National Grid's website.
[5] Please see Uniform Network Code, Transportation Principal Document Section B for further details. The full text of the UNC is published on the website of the Joint Office of Gas Transporters.
[6] The TPCR4 rollover price control was a one-year extension (from 1 April 2012 to 31 March 2013) of the TPCR4 price control which ended on 31 March 2012.
[7] The RIIO-T1 price control is the current 8-year price control for gas and electricity transmission, running from 1 April 2013 to 31 March 2021.
[8] The funding is being provided as additions to NGGT's regulatory asset value (RAV) starting in

we were clear that this would be "trued up" to actual efficient expenditure once this was known. This comprises £9.2 million that was provided during the TPCR4 rollover year and a further £268.3 million that was provided for the RIIO-T1 period.[10] NGGT has reported zero expenditure during the relevant period (April 2012 to date). No expenditure is forecast for the remainder of the current price control period.

Proposed treatment of price control funding

1.7. We have considered three options for the price control funding:

- **Option 1:** Do nothing.
- **Option 2:** True up the price control allowances for the £277.5 million to actual and currently forecast expenditure over the RIIO-T1 period (zero).
- **Option 3:** True up the price control allowances at the end of RIIO-T1 for £277.5 million to actual expenditure.

Option 1: Do nothing

1.8. We consider that truing up the allowances made as part of the TPCR4 rollover and RIIO-T1 price controls is in the interest of consumers. Doing so will ensure that consumers are not funding expenditure that has not taken place. Truing up is also consistent with the intent of the original arrangements under which the allowances were provided. For these reasons, we do not think that doing nothing under Option 1 is viable.

Options 2 & 3: Truing up the price control allowances (now or at the end of RIIO-T1)

1.9. We think Option 2 (true up now) is better than Option 3 (true up later) for the following reasons.

- The allowances would start feeding through to consumer bills (via shippers) from 1 April 2017. Under Option 2, consumers would benefit from the adjustment

April 2017. The RAV additions would start affecting NGGT's annual allowed revenues from 1 April 2017.

[9] The triggering of the entry capacity obligation at Fleetwood in 2006 also led to the release of funding for NGGT under the price control arrangements prevailing at the time. This is not subject to this review.

[10] In our November 2016 open letter that announced this review, we only included the RIIO-T1 funding. As a result of our review we now consider that the funding from the TPCR4 rollover year should also be in scope of this review.

sooner (ie in the year starting 1 April 2018), whereas under Option 3, consumers would only benefit in 2022.

- Based on information provided to us by NGGT, the possibility that any expenditure would be incurred in the remainder of this price control period is remote.

1.10. Under Option 2, NGGT would be exposed to the risk of unfunded expenditure in the future for as long as the associated capacity obligation remains in place. Given the lead time necessary for development, and NGGT's own forecasts, this risk is low in RIIO-T1. We would consider any future funding requests as part of the next price control. In the next chapter, we consider the funding implications of the different options we are considering on the capacity obligation.

Conclusion

1.11. Our preference is to true up NGGT's allowances now (Option 2). This option ensures that consumers will not be funding NGGT for work which has not taken place. Truing up allowances now ensures that consumers will benefit sooner from the removal of these costs.

1.12. We note that there is a similar funding structure in RIIO-T1 for NGGT to address exit capacity needs in the South West Quadrant of the NTS.[11] We provided NGGT funding of £40.7 million for this. We plan to review this in later years or at the end of RIIO-T1.

[11] The South West Quadrant refers to a section of the NTS in the South West region of England.

2. Proposed treatment of the Fleetwood capacity obligation

Chapter summary

This chapter sets out the options we are considering for the treatment of National Grid's entry capacity obligation at Fleetwood.

Question 1: What are your views on our proposed options for the capacity obligation at Fleetwood?

Question 2: Are there any other options that you think we should consider?

2.1. Any decision we make on NGGT's price control funding does not automatically affect NGGT's obligation under its licence to offer entry capacity at Fleetwood.

2.2. Nevertheless, we think that the funding issue cannot be considered in isolation from the capacity obligation, because the funding was provided to remunerate NGGT for the cost of meeting the obligation. We have therefore included the entry capacity obligation at Fleetwood within the scope of our review.[12]

Our objectives

2.3. In reviewing the capacity obligation, we have focused on the following high level objectives.

- To protect the interests of current and future energy consumers by preserving the user commitment principle, which has governed our approach to new National Transmission System (NTS) entry capacity since 2003.
- To maintain a stable, predictable and non-discriminatory regulatory environment for users of the NTS, including shippers, developers and potential investors in projects requiring access to the NTS.

2.4. We believe that the user commitment protects consumers in two ways:

[12] This is consistent with our previous statements on this issue. For example, we said in our Fleetwood Income Adjusting Event decision letter that "the way forward needs to recognise that the obligations on NGG to provide capacity go hand in hand with the remuneration they receive."

- By requiring potential users of NTS capacity to commit to funding a share of the deemed cost of accommodating the capacity, the user commitment limits the exposure of future consumers.

- The user commitment helps promote efficient investment in the NTS by ensuring that shippers, developers and investors in new projects take account of the deemed costs of network investment in their investment decisions.

2.5. The user commitment targets a reasonable balance of cost recovery between consumers and users requiring new capacity, by requiring successful bidders to commit to funding at least 50 per cent (in net present value terms) of assumed project costs.

2.6. We are concerned that the situation at Fleetwood undermines the user commitment principle. The original user commitment at Fleetwood was made by Canatxx in 2006.[13] However, Canatxx's failure to secure planning permission for its project and its subsequent default meant that it lost its right to the capacity, and the financial obligations associated with it were dropped. This means that there is no longer a user commitment underpinning the capacity obligation at Fleetwood.

Options

2.7. We are considering the following options as part of our review:

- **Option 1**: Do nothing now. Leave the capacity obligation at Fleetwood as it currently stands (650 GWh/day).

- **Option 2**: Remove the capacity obligation at Fleetwood now.

- **Option 3**: Amend the capacity obligation at Fleetwood to reduce the level of obligated entry capacity (eg to 350 GWh/day).

Option 1: Do nothing now. Leave the capacity obligation at Fleetwood as it currently stands (650 GWh/day).

2.8. Under Option 1, NGGT will continue to offer the capacity for sale at auctions to shippers. NGGT runs a range of auctions to sell entry capacity, from short term auctions (eg within day) to long term auctions (for three-monthly periods up to 16 years in advance). Under current arrangements, all auctions have a reserve price, but the reserve price for very short term auctions can be zero.

[13] Canatxx committed to paying approximately £114m between 2010/11 and 2016/17 for the use of 650 GWh/d of capacity.

2.9. Moreover, without user commitment or competing users, shippers can buy capacity when they might need it (eg winter periods only) at low prices, rather than reserving capacity for a longer duration. This has manifested at Fleetwood, where a shipper has bought 350 GWh/day of entry capacity at Fleetwood for use in one quarter of 2025 for £252,000. As of now, the capacity is unsold for use at all other times.

2.10. Offering the obligated level of capacity at Fleetwood for sale at auction exposes NGGT to the risk that it may need to reinforce its network if the capacity is sold. This risk becomes bigger once a shipper is physically able to nominate gas flows into the NTS as NGGT might need to undertake constraint management actions at that time. NGGT would expect to be funded through its price control for taking on this risk. If we true up the funding now (option 2 in the previous chapter), we would consider the appropriate funding NGGT needs to meet its obligations. This is likely to be considered as part of the next price control review.

2.11. Had it progressed, the original user commitment from Canatxx would have, as intended, covered a substantial proportion of the deemed cost of network investment at Fleetwood. In the absence of this commitment, it is uncertain whether the revenue from selling the Fleetwood capacity at auctions would make up for the loss of this commitment.[14] This means that customers are potentially exposed to any costs incurred by NGGT to provide capacity at Fleetwood.

2.12. It is difficult to estimate precisely the costs to which consumers could be exposed. At the time of setting the RIIO-T1 price control in 2012, NGGT estimated that it would need to invest £269.1 million in its network if Canatxx's gas storage project was to go ahead.[15] The size of the storage project, network conditions and overall gas demand have changed since then, and may change further before the entry point is actually needed. This means that the scale of investment required at the time of need is highly uncertain.

2.13. There are several entry points on the network that are not backed by user commitment. However, since 2003, Fleetwood is the only entry point where incremental capacity has been released without being supported by a user commitment. Moreover, the Fleetwood entry point has never been used, and no physical infrastructure has been built to accommodate flows from Fleetwood.

2.14. The lack of user commitment can also distort competition between potential users of capacity at Fleetwood and users at other points on the NTS. Users requiring new capacity elsewhere on the network would have to make an upfront financial

[14] This assessment is based on current gas transmission capacity charging arrangements. These arrangements are currently under review, and it is possible that capacity charges are substantially different in the future. Please see our recent open letter on this issue (Ofgem 2017, Open letter on the European Union Network Code on harmonised transmission tariff structures for gas (TAR NC))
[15] This estimate was provided to us by NGGT as part of its Business Plan submissions for the RIIO-T1 price control. We eventually allowed £268.3 million in our Final Proposals. This was in addition to the £9.2 million we allowed for 2012/13.

commitment that passes the test. If we were to fund the creation of new capacity at Fleetwood without a user commitment, we could be giving users who are in a position to utilise capacity at Fleetwood an undue competitive advantage over other new users.

Option 2: Remove the capacity obligation at Fleetwood now.

2.15. Under Option 2, we would amend NGGT's licence to remove the existing capacity obligation at Fleetwood.

2.16. This means that any user requiring entry capacity at Fleetwood in the future would have to trigger the release of new entry capacity. This involves making a fresh user commitment to pay at least 50 per cent (in net present value terms) of the assumed cost of network investment required to accommodate the capacity requirement.

2.17. The cost of making a fresh user commitment to successfully trigger the release of entry capacity at Fleetwood is uncertain. The financial commitment required depends on NGGT's deemed cost of investment required on the NTS.

2.18. This uncertainty means that it is difficult to predict whether the cost of the fresh user commitment would be higher or lower than the cost of buying an equivalent amount of capacity at auction under the status quo. However, as the user commitment is linked to the deemed cost of investing in the network, requiring a new commitment protects consumers by limiting their potential exposure to network investment costs.

2.19. We are also mindful of the need to maintain a stable and predictable regulatory environment for users of the NTS. We have never previously removed capacity obligations in their entirety at an entry point.[16]

2.20. We have also previously said that seeking to remove the capacity obligation at Fleetwood without the consent of the parties involved could be seen as undermining the regulatory regime and be detrimental to consumers.[17] However, we do not think removing the capacity obligation runs contrary to our obligations to users of the NTS. In the same document, we also said that the capacity and funding go hand-in-hand, and that it would not be appropriate to remove the funding without also removing the capacity obligation. Furthermore, in our RIIO-T1 Final Proposals, we clearly indicated that we would keep the situation at Fleetwood under review, and that we may take action that could affect the treatment of capacity at Fleetwood.

2.21. Removing the capacity obligation means that NGGT would no longer be obliged to offer entry capacity for sale at Fleetwood. That would not affect any

[16] As part of a previous price control decision (TPCR4), we reduced obligated capacity levels at a number of entry points.
[17] Fleetwood Income Adjusting Event final decision document, available here.

capacity contracts that may have been entered into before the obligation is removed. In particular, it would not affect the single tranche of capacity that has already been sold for use in 2025, and any other tranches of capacity that may be sold before the capacity obligation is removed.

2.22. We consider it unlikely that the shipper that has bought the capacity in 2025 would nominate gas flows without taking steps to ensure that entry capacity is available on a more sustainable basis, ie by triggering the release of new entry capacity. A shipper would need to install substantial infrastructure before any gas could physically flow into the NTS at Fleetwood, and it seems unlikely that a shipper would undertake this investment without ensuring sustained access to entry capacity. In the unlikely event that flows are nominated in 2025 without the release of new entry capacity, and NGGT is physically unable to accept the flow, it is likely that the most efficient means of honouring the sale would be through constraint management action, rather than network investment.[18]

2.23. To the extent that NGGT expects to incur any expenditure in honouring any pre-existing contracts, adequate funding would be provided under an appropriate future price control settlement.[19]

2.24. It is possible that additional tranches of capacity are purchased at auction before we make our final decision. In that case we will consider the implications of the purchases on the arguments for and against each option before making our final decision.

Option 3: Amend the capacity obligation at Fleetwood to reduce the level of obligated entry capacity (350 GWh/day).

2.25. Option 3 involves reducing the level of obligated entry capacity at Fleetwood to the level that has been previously sold at auction (350 GWh/day). A clear signal has been received through the sale of capacity in 2025 that capacity is needed at this level (albeit for just one quarter).

2.26. We would expect the level of investment required on the network to accommodate 350 GWh/day to be lower than what would be required to accommodate 650 GWh/day. This means that consumers' exposure to potential network costs would be lower than under the status quo.

[18] NGGT can "buyback" sold entry capacity by making appropriate constraint payments to holders of capacity rights. These payments are linked to the wholesale cost of gas. NGGT is funded for such action under the RIIO-T1 price control, specifically under the mechanism set out in Special Condition 3B of its licence. NGGT is exposed to 44.36% of cost of any constraint management action subject to a cap and collar.
[19] The single tranche of capacity that has been sold so far is for use in 2025. Any constraint management costs associated with this tranche would fall within the scope of the price control applying in that year.

2.27. Retaining the smaller amount of obligated capacity also ensures that the user that has signalled the need for capacity is able to buy this level of capacity at auction, without having to meet the user commitment test.

2.28. We are mindful, however, that reducing the obligated capacity to the level already sold could be seen as giving preferential treatment to the shipper that has bought this level of capacity. Any user requiring capacity at Fleetwood in excess of this level would still need to make a user commitment to trigger the release of entry capacity, whereas under the status quo they would have been able to buy up to a maximum of 650 GWh/day at auction.

Conclusion

2.29. We think that the choice between the three options is finely balanced. Our initial thinking is that removing the capacity obligation altogether (Option 2) would best protect the interests of current and future consumers.

2.30. Removing the capacity obligation preserves the user commitment principle, and ensures that any future user of entry capacity at Fleetwood commits to paying a fair share of the assumed cost of providing the capacity.

2.31. Removing the obligation does not mean that capacity would not be available to users. Users would still be able to trigger the release of entry capacity by making the appropriate level of user commitment.

Appendix 1 - Feedback on this consultation

We want to hear from anyone interested in this document. Send your response to the person or team named at the top of the front page.

We've asked for your feedback in each of the questions throughout it. Please respond to each one as fully as you can.

Unless you mark your response confidential, we'll publish it on our website, www.ofgem.gov.uk, and put it in our library. You can ask us to keep your response confidential, and we'll respect this, subject to obligations to disclose information, for example, under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004. If you want us to keep your response confidential, you should clearly mark your response to that effect and include reasons.

If the information you give in your response contains personal data under the Data Protection Act 1998, the Gas and Electricity Markets Authority will be the data controller. Ofgem uses the information in responses in performing its statutory functions and in accordance with section 105 of the Utilities Act 2000. If you are including any confidential material in your response, please put it in the appendices.

General feedback

We believe that consultation is at the heart of good policy development. We are keen to hear your comments about how we've conducted this consultation. We'd also like to get your answers to these questions:

1. Do you have any comments about the overall process of this consultation?
2. Do you have any comments about its tone and content?
3. Was it easy to read and understand? Or could it have been better written?
4. Were its conclusions balanced?
5. Did it make reasoned recommendations for improvement?
6. Any further comments?

Please send your comments to stakeholders@ofgem.gov.uk