UNC Modification

At what stage is this document in the process?

01 Modification

02 Workgroup Report

03 Draft Modification Report

04 Final Modification Report

UNC 0XXX:

Removal of Entry Capacity Revenue from Capacity Neutrality Arrangements

Purpose of Modification:

The purpose of the Modification is to remove capacity revenues recovered from daily interruptible and within day Entry Capacity from Capacity Neutrality arrangements prospectively from the implementation date. Following implementation of UNC Modification 0678A on 1st October 2020 an increasing proportion of revenue is subject to neutrality so there is a need to urgently review the operation of the current Capacity Neutrality arrangements as the redistribution of some sources of such revenues is no longer appropriate.

The Proposer recommends that this Modification should be:

- treated as urgent and should proceed as such under a timetable agreed with the Authority

High Impact:

All parties that hold NTS Entry Capacity and National Grid NTS.

Medium Impact:

None

Low Impact:

None

Contents

Timetable

The Proposer recommends the following timetable:	
Modification Proposal sent to Ofgem	07 December 2020
Ofgem decision on Urgency	08 December 2020
Modification Proposal issued for consultation	08 December 2020
Consultation Close-out for representations	11 December 2020
Final Modification Report available for Panel	15 December 2020
Modification Panel recommendation	17 December 2020
Final Modification Report issued to Ofgem	17 December 2020

Any questions?

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1 Summary

What

The UNC TPD (Section B2.13) and EID (Section B11.5) currently details that the revenues received by National Grid from Entry Capacity Charges in respect of within day Daily NTS Entry Capacity and Daily Interruptible NTS Entry Capacity ('**Relevant Entry Capacity**') are subject to Capacity Neutrality arrangements whereby National Grid NTS is held cash neutral by the subsequent return of such revenues to Users of the NTS.

As a consequence, the revenue that National Grid is entitled to recover from the provision of such Entry Capacity on the NTS has to be recovered from Users' procurement of other Entry Capacity products (i.e. those that are not subject to the aforementioned neutrality arrangements).

Why

The NTS Charging Methodology in place prior to October 2020 facilitated recovery of National Grid's Allowed Revenue principally from flow based 'commodity' charges and long term capacity products. Indeed, the vast majority of short term Entry Capacity was available at low or zero unit cost (i.e. interruptible / offpeak / within day firm). The socialisation of such relatively low revenue values under the Capacity Neutrality mechanism therefore had no material impact on recovery of National Grid's Allowed Revenue.

Following the implementation of the current NTS Charging Methodology on 1st October 2020 an increasing proportion of overall revenue is from Relevant Entry Capacity products which now have a higher unit cost compared to pre-October 2020. For instance interruptible / off peak capacity is now priced at 90% of the costs of the equivalent firm Capacity, as opposed to having a reserve price of zero prior to October 2020. The consequence of this is that a material proportion of revenue from Entry Capacity is now subject to Capacity Neutrality and therefore does not contribute to the collection of National Grid's Allowed Revenue. This has resulted in a significant proportion of revenue being distributed back to Users which is not consistent with the wider aims of the charging regime to secure effective competition and to take account of developments in the transportation business, specifically the increase in revenue subject to neutrality arrangements.

If no action is taken to address the issue, the un-anticipated scale of revenue subject to neutrality arrangements is expected to result in a significant under recovery of National Grid's Allowed Revenue in Formula Year 2020/21 and require a material proportion of revenue to be recovered via the Transmission Services Revenue Recovery Charge (TSRRC). This will increase overall price volatility for Users if this is not addressed in a timely manner.

How

It is proposed that the revenues received by National Grid from Relevant Entry Capacity charges are no longer subject to Capacity Neutrality arrangements from the date of implementation. For the avoidance of doubt, Capacity Neutrality will continue to operate in respect of the remaining costs and revenues (for example, overruns). This means that a greater proportion of Entry Capacity sales will contribute towards the efficient recovery of National Grid's Allowed Revenue.

2 Governance

Justification for Urgency

This Modification should be treated as urgent and should proceed under a timetable approved by the Authority. A proposed timeline is provided in the 'Timetable' section of this Proposal.

Urgent status is sought on the basis that this is an imminent issue and as such there is a need to address this issue as soon as practicable to minimise the impact on those paying Transportation Charges and those who are paying into Capacity Neutrality and receiving a proportion of the redistribution thereof and mitigate a significant commercial impact. Urgent resolution seeks to reduce the time where the current issue would be in place to provide certainty to both Users, the wider market and National Grid. The longer the issue remains unaddressed will increase the likely impact on Users as it impacts the levels of any charges to manage revenue recovery within this Formula Year and potentially into subsequent Formula Years. A timely resolution will minimise, as much as possible, the volatility of the Transportation Charges.

To this extent, the need for this issue to be address is being driven by an imminent date related issue to change the Capacity Neutrality process and minimise the impact which, using October 2020 as an example, could be in the order of £0.5 million per day (£15 million per month).

If this is not urgently addressed, this may necessitate a greater utilisation of the TSRRC within the current Formula Year (and potentially subsequent Formula Years) to recover a material proportion of National Grid's Allowed Revenue. As this Entry Capacity charge is levied to all Entry Capacity holders (except Existing Available Holdings as per UNC TPD Section B2.11.7 and Y2.2.2) this would have the unintended consequence of socialising costs of the provision of Relevant Entry Capacity.

This socialisation takes effect as the cost of short-term capacity is paid for by Users holding Relevant Entry Capacity, however this revenue is returned to all User via Capacity Neutrality. Therefore there may be distributional impacts on all Users if the method by which neutrality payments are returned to Users differs to the way they are recovered via the TSRRC.

As set out elsewhere in this Proposal, the unanticipated increase in revenue subject to Capacity Neutrality has therefore resulted in arrangements for revenue distribution via Capacity Neutrality that are not consistent with the objectives of the charging methodology as set out in Standard Special Condition A5(5) of the NTS Licence.

As a result, this poses a significant commercial impact on all parties mentioned and will, in turn, have impacts for the reciprocal charges levied to customers and for interested stakeholders of NTS customers and how they in turn recover costs and charge for their recovery, potentially across multiple years.

Justification for Authority Direction

This Modification Proposal is recommended for Authority direction as it is likely to have a material effect on commercial activities relating to the shipping, transportation and supply of gas because, if implemented, it is likely to have a material impact on the allocation of charges across Users.

Requested Next Steps

This Modification should:

- be considered a material change and not subject to self-governance
- be treated as urgent and should proceed as such under a timetable agreed with the Authority

3 Why Change?

Capacity Neutrality

The UNC TPD Section B2.13.2 provides that 'Relevant Capacity Revenues' are subject to the Capacity Neutrality mechanism set out in B2.13.3 to B2.13.7. The UNC EID Section B11.5 adds into Relevant Capacity Revenues certain revenues from the equivalent Entry Capacity at Interconnection Points.

Relevant Capacity Revenues include amounts payable to National Grid NTS by Users by way of Capacity Charges in respect of:

- Daily NTS Entry Capacity that is registered on the day (TPD Section B2.13.2(a)(i)(1));
- Daily Interruptible NTS Entry Capacity (TPD Section B2.13.2(a)(i)(2));
- any additional Firm NTS Entry Capacity made available in excess of Unsold NTS Entry Capacity (TPD Section B2.13.2(a)(i)(3));
- Monthly NTS Entry Capacity allocated by reason of the acceptance of a rolling monthly surrender offer (TPD Section B2.13.2(a)(i)(4)).
- NTS Entry Capacity allocated in any Interruptible Day-ahead Auction or Within-Day Auction (EID Section B11.5.1(a)(i)); and
- Interconnection Point Capacity comprising quantities subject to Surrender Offers or Withdrawal Offers (EID Section B11.5.1(a)(ii)).

The operation of the Capacity Neutrality arrangements means that National Grid NTS is held cash neutral by the subsequent return of such revenues to Users of the NTS.

As a consequence, the revenue that National Grid is entitled to recover from the provision of Entry Capacity on the NTS has to be recovered from Users procurement of other Entry Capacity products (i.e. those that are not subject to the aforementioned Capacity Neutrality arrangements).

Recovery of National Grid's Allowed Revenue

National Grid NTS is permitted by its Licence to recover amounts equal to its Allowed Revenue for provision of Transportation services to Users of its network (the NTS). The NTS Charging Methodology (UNC TPD Section Y Part A) sets out the principles applied by National Grid NTS in the setting of Transportation Charge rates to enable recovery of its Allowed Revenue in each Formula Year.

The NTS Charging Methodology in place prior to October 2020 ('*the previous Methodology*') facilitated recovery of National Grid's Allowed Revenue principally from flow based 'commodity' charges and long-term capacity products. Indeed, the vast majority of short-term capacity was available at low or zero unit cost (i.e. interruptible / offpeak / Within Day Firm). The socialisation of such relatively low revenue values under the Capacity Neutrality mechanism therefore had no material impact on recovery of National Grid's Allowed Revenue.

Due in part to the lack of predictability and instability of charge rates under the previous Methodology (which, due to capacity booking behaviours, resulted in an increasing reliance on flow-based commodity charges to recover revenues) and the need to comply with the newly introduced EU Tariff Code, Modification 0678A introduced a new NTS Charging Methodology ('*the new Methodology*') from 1st October 2020.

In order to comply with the EU Tariff Code, the new Methodology provided for a principally capacity-based charging regime which enables National Grid to recover the majority of its Allowed Revenue via this regime. Where in the Formula Year there is forecast to be a difference between Allowed Revenue and the aggregate amount expected to be collected from capacity charges, the new Methodology provides for a TSRRC to be applied to reconcile the two values.

Impacts of Current Capacity Neutrality Arrangements

Following the implementation of the new Methodology on 1st October 2020 a material proportion of revenue from Entry Capacity is now classified as Relevant Capacity Revenue and therefore subject to Capacity Neutrality. Accordingly, such revenue does not contribute to the collection of National Grid's Allowed Revenue.

If no action is taken to address the issue, the current arrangements will continue resulting in a significant under recovery of National Grid's Allowed Revenue in Formula Year 2020/21 and continue to have a negative impact on price volatility for the impacted charges.

The suitability of the Capacity Neutrality arrangements needs to be considered as the consequential revenue distribution via Capacity Neutrality is not consistent with the objectives of the charging methodology as set out in Standard Special Condition A5(5) of the NTS Licence. Specifically, it is not consistent with relevant methodology objectives:

- (b) *to take account of developments in the transportation business* on the basis that the prevailing Capacity Neutrality arrangements are no longer fit for purpose as they have not taken account of the implications of the increased proportion of revenue subject to neutrality arrangements from October 2020; and

- (c) to facilitate effective competition between shippers on the basis that the revenue distributed as a consequence of the operation of the prevailing Capacity Neutrality arrangements do not effectively target costs to those Users that accrue the benefit of the procurement of capacity.

This socialisation takes effect as aggregate revenues from Users contributing to Capacity Neutrality are not redistributed to the such Users in the equivalent proportions. This is because Capacity Neutrality as an overall 'pot' is redistributed on the proportions of User's Fully Adjusted Firm Available NTS Entry Capacity as system wide total of the Fully Adjusted Firm Available NTS Entry Capacity. Therefore, in summary there are distributional impacts on all Users if the method by which neutrality payments are returned to Users differs to the way they are recovered via the TSRRC.

By way of illustration to use two potential scenarios:

- A User may not have Capacity secured by auction (i.e. by trading the capacity in where the liability remains with the original holder) and therefore not pay any Capacity Charges direct to National Grid and will receive a proportion for the Capacity Neutrality redistribution;
- a User that is wholly an Interruptible Capacity User whereby the Interruptible Capacity is paid however would receive no proportion of the Capacity Neutrality redistribution as the redistribution is on the basis of a percentage of firm capacity.

Preferred Option to Address the Issue

Having considered the relative merits of the range of options to address this matter, our preferred solution is to remove the relevant short-term Entry Capacity revenue from the Capacity Neutrality mechanism. The historic rationale for inclusion of such revenue in Capacity Neutrality was to keep the System Operator neutral to constraint management costs. In practice, inclusion of the relevant revenues into the neutrality process was to offset Entry capacity constraint costs and therefore minimise cost exposure wherever possible to those multiple parties. Under this arrangement, the Allowed Revenue would be collected from other revenue sources.

The proposed solution would remove the difference between the treatment of revenues for long-term and short-term Entry Capacity bookings respectively. Whilst under the previous Methodology there was a diverse range of other charges from which to collect Allowed Revenue (i.e. charges for long term capacity, and flow-based commodity charges) differential treatment represented a logical approach. However, the move to a principally capacity based revenue recovery model from 1st October 2020 and the increased proportion of revenue now subject to neutrality arrangements means that National Grid NTS is now of the opinion that the rationale for inclusion of Relevant Entry Capacity revenue in Capacity Neutrality is no longer valid and on this basis it is inappropriate for this revenue to continue to be subject to Capacity Neutrality.

This solution will also remove the potential requirement (if the issue is not addressed) to potentially significantly increase the charge rates for long term Entry Capacity (excluding Existing Available Holdings) in order to seek to recover Entry Capacity revenue in future years from those capacity elements that are *not* subject to Capacity Neutrality. This would exacerbate the issue by making long term Entry Capacity even less commercially attractive to Users. This would also remove the risk of having to utilise the TSRRC to recover a material proportion of National Grid's Allowed Revenue. This will ensure that this charge is appropriately limited to making relatively small 'fine tuning' adjustments to overall collected revenue, this being its true purpose.

To enable National Grid to take action to address this issue in a timely manner (thereby minimising the scale of the impact) it is necessary for the existing minimum notice period requirements for changes to the TSRRC rates to be waived for a TSRRC rate change as a consequence of the implementation of this Proposal. Retaining the requirement to provide a notice period of two months on this occasion would effectively delay the action National Grid could take to address this matter thereby requiring a higher value correction to address it.

4 Code Specific Matters

Reference Documents

UNC TPD Section B

UNC EID Section B

UNC TPD Section Y

UNC Modification 0678A

Knowledge/Skills

Knowledge of the treatment of capacity revenues and charging principles would be beneficial.

5 Solution

It is proposed that the following sources of revenue relating to provision of Entry Capacity are no longer treated as Relevant Capacity Revenues from the date of implementation and are not therefore subject to Capacity Neutrality:

- Daily NTS Entry Capacity (TPD Section B2.13.2(a)(i)(1)). Note this does not include Non-obligated Daily NTS Entry Capacity;
- Daily Interruptible NTS Entry Capacity (TPD Section B2.13.2(a)(i)(2));

- NTS Entry Capacity allocated in any Interruptible Day-ahead Auction or Within-Day Auction (EID Section B11.5.1(a)(i)).

It is also proposed that the minimum 2 months notice period for notification of a revision to Entry TSRRC or Exit TSRRC rates for a Gas Year (as per TPD Y3.3.3 and TPD B1.8.2(b)) are waived for a revision to such rates as a consequence of the implementation of this Proposal. Accordingly, on this occasion, the minimum notice period for changes to the above mentioned charge rates will be five Business Days (this being the minimum notice period for implementation of this Proposal as specified in section 8). For the avoidance of doubt, the effective date of the associated TSRRC rate change would be the first calendar day of a month.

6 Impacts & Other Considerations

Does this Modification impact a Significant Code Review (SCR) or other significant industry change projects, if so, how?

No such impacts have been identified.

Consumer Impacts

There will potentially be an impact on different consumer groups but the Allowed Revenue (determined in line with National Grid's Licence) which is collected by National Grid NTS will not change in the event of implementation of this Proposal. This Proposal will essentially apportion Transportation costs to Users of the NTS in a way that National Grid believes is fairer, more proportionate and better aligned to the EU Tariff Code principles than the current revenue arrangements deliver with a greater proportion of Entry Capacity revenue (regardless of whether they are short or long terms products) contributing towards the collection of National Grid NTS' Allowed Revenue.

The nature of how the Users' Transportation charge liability is charged downstream from UNC arrangements will depend on how Users and other market participants structure their respective contracts and associated service charges.

Cross Code Impacts

No direct cross code impacts have been identified

EU Code Impacts

EU Tariff Code principles have been considered as part of this Proposal in respect of the stated purpose of the capacity Reference Price Methodology ("…*the methodology applied to the part of the transmission services revenue to be recovered from capacity-based transmission tariffs*") and Revenue Recovery charges ("…*levied for the purpose of managing revenue under- and over-recovery*").

This Modification maintains alignment with EU Code requirements.

Central Systems Impacts

There will be impacts on [Gemini and UK Link invoicing] systems. These impacts are being assessed.

7 Relevant Objectives

Impact of the modification on the Relevant Objectives:

Relevant Objective	Identified impact
a) Efficient and economic operation of the pipe-line system.	None
b) Coordinated, efficient and economic operation of (i) the combined pipe-line system, and/ or (ii) the pipe-line system of one or more other relevant gas transporters.	None
c) Efficient discharge of the licensee's obligations.	Positive
d) Securing of effective competition: (i) between relevant shippers; (ii) between relevant suppliers; and/or (iii) between DN operators (who have entered into transportation arrangements with other relevant gas transporters) and relevant shippers.	Positive
e) Provision of reasonable economic incentives for relevant suppliers to secure that the domestic customer supply security standards… are satisfied as respects the availability of gas to their domestic customers.	None
f) Promotion of efficiency in the implementation and administration of the Code.	None
g) Compliance with the Regulation and any relevant legally binding decisions of the European Commission and/or the Agency for the Co-operation of Energy Regulators.	Positive

Demonstration of how the Relevant Objectives are furthered:

c) Efficient discharge of the licensee's obligations.

The proposed changes in this Modification better align the treatment of entry capacity revenues with the new Methodology and arrangements. Implementation of this Proposal would enable more efficient collection of Allowed Revenue (as provided for in the Special Conditions of our Licence) as opposed to the alternative approach of recovering a material proportion of National Grid NTS' Allowed Revenue via the TSRRC.

d) Securing of effective competition between relevant shippers;

The proposed changes in this Modification are expected to provide a more stable and predictable price setting regime (specifically in respect of Entry Capacity and TSRRC), Shippers will have a greater level of confidence in their forecasts of prospective use of network costs and therefore set their own service costs more accurately (potentially with a lower risk margin) thereby enhancing effective competition.

g) Compliance with the Regulation and any relevant legally binding decisions of the European Commission and/or the Agency for the Co-operation of Energy Regulators.

The proposed changes in this Modification will ensure that the revenue recovery arrangements better align with the EU Tariff Code principles relating to the purposes of the Reference Price Methodology and the TSRRC.

Section Y (Charging Methodology) Modifications

Impact of the modification on the Relevant Charging Methodology Objectives:

Relevant Objective	Identified impact
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;	Positive
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;	None
b) That, so far as is consistent with sub-paragraph (a), the charging methodology properly takes account of developments in the transportation business;	Positive
c) That, so 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	Positive
d) That the charging methodology reflects any alternative arrangements put in place in accordance with a determination made by the Secretary of State under paragraph 2A(a) of Standard Special Condition A27 (Disposal of Assets).	None
e) Compliance with the Regulation and any relevant legally binding decisions of the European Commission and/or the Agency for the Co-operation of Energy Regulators.	None

Demonstration of how the Relevant Objectives are furthered:

a) charges reflect the costs incurred by the licensee in its transportation business

implementation of this Modification will adjust the revenue distribution (as a consequence of the operation of the prevailing Capacity Neutrality arrangements) from the implementation date as the prevailing arrangements do not enable National Grid to recover material amounts of revenue from the sale of capacity in its network.

b) properly takes account of developments in the transportation business

implementation of this Modification will effectively adjust the arrangements from the implementation date. On this basis, from this point the arrangements will have appropriately taken account of developments in the transportation business observed since October 2020.

c) facilitates effective competition between gas shippers and between gas suppliers

implementation of this Modification will adjust the revenue distribution (as a consequence of the operation of the prevailing Capacity Neutrality arrangements) from the implementation date as the prevailing arrangements do not effectively target costs incurred by National Grid in the provision of capacity to those Users that accrued the benefit of that capacity. Effective targeting of costs in line with the methodology is a necessary cornerstone of competition.

8 Implementation

Implementation of this Proposal should take effect as soon as practicable noting that implementation is required to take effect from the first calendar day of a month. On this basis, implementation is proposed to take effect from the first calendar day of the month following the date of the notice from the Authority directing the implementation of this Proposal (subject to a minimum period of five Business Days between the date of the Authority notice and the date of implementation).

Alternatively, the implementation date will be as directed by the Authority.

For the purposes of illustration, the following table shows the expected Implementation Date in the event of a direction to implement this Proposal being issued in the timescales indicated:

Modification Proposal Direction Date	First available Implementation Date
Up to and including 22nd December 2020	1 January 2021
23rd December to 22 January 2021 (inclusive)	1 February 2021
23 January 2021 to 19 February 2021 (inclusive)	1 March 2021
20 February to 24 March 2021 (inclusive)	1 April 2021

Update of the TSRRC rate will take effect at the earliest opportunity with a notice period of less than 2 months but no less than [5] business days.

The current Formula Year ends on 31st March 2021 hence a timely decision will enable National Grid NTS to include the relevant revenues from short term Entry Capacity in its Allowed Revenue at the earliest opportunity and therefore limit the scale of change to Entry Capacity and Transmission Service Revenue Recovery charge rates ahead of the end of the current Formula Year. Equivalent benefit will also be realised in future Formula Years.

9 Legal Text

Text Commentary

Insert text here

Text

Insert text here

10 Recommendations

Proposer's Recommendation

This Modification should be treated as urgent and should proceed as such under a timetable approved by the Authority.