

Representation - Draft Modification Report

**UNC 0621; 0621A; 0621B; 0621C; 0621D; 0621E; 0621F; 0621H; 0621J; 0621K*; 0621L
Amendments to Gas Transmission Charging Regime**

*** Amendments to Gas Transmission Charging Regime and the treatment of Gas Storage**

Responses invited by: 5pm on 22 June 2018

To: enquiries@gasgovernance.co.uk

Representative:	Alastair Tolley
Organisation:	EP UK Investments Ltd (EPUKI)
Date of Representation:	22 June 2018
Support or oppose implementation?	0621 - Comments 0621A - Comments 0621B - Comments 0621C - Comments 0621D - Oppose 0621E - Comments 0621F - Comments 0621H - Comments 0621J - Comments 0621K - Comments 0621L - Comments
Expression of Preference:	<i>If either 0621; 0621A; 0621B; 0621C; 0621D; 0621E; 0621F; 0621H; 0621J; 0621K or 0621L were to be implemented, which <u>ONE</u> modification would be your preference?</i> 0621B
Standard Relevant Objective:	Given that the majority of the proposals are incomplete in respect of the enduring period, we have been unable to reach a conclusion as to whether these modifications are positive or negative for the Relevant Objectives.
Charging Methodology Relevant Objective:	Given that the majority of the proposals are incomplete in respect of the enduring period, we have been unable to reach a conclusion as to whether these modifications are positive or negative for the Relevant Objectives.

Reason for support/opposition and preference: Please summarise (in one paragraph) the key reason(s)

EPUKI has found it difficult to assess and form a clear preference on the UNC0621 modifications because many of the proposals are incomplete in respect of the enduring period. 0621B is our preferred solution on the basis that it is the only complete and enduring solution for reform which also continues to recognise the benefit of shorthaul in a similar way to today.

More work is required to develop the reform proposals

EPUKI has found it difficult to assess and form a clear opinion on the UNC0621 proposals. Although discussions on reforms to the NTS charging methodology have been ongoing for several years, it appears that a large number of proposals (some of which are only subtly different) have been brought forward relatively late in the process, meaning that the industry has had insufficient time properly to consider all the issues raised. Most of the proposals fail to specify some key design elements of the enduring regime, without which the whole impact of the modification cannot be assessed. Furthermore, the limited analysis published in support of the modifications has not been presented in a way which is easy to digest and was updated during the consultation window giving us insufficient time appropriately to consider it.

Given the scale of change to charges that may result from these modifications, it is crucial that the proposals are not rushed to decision if defects and scope for further analysis are identified. As most of the proposals are fundamentally incomplete, we do not consider it is possible to reach a conclusion as to whether they are positive or negative for the Relevant Objectives. EPUKI therefore considers that substantially more analysis and design work is required before the Panel or Ofgem can reach a decision on these proposals.

Given the variety of options put forward, it may be the case that none of the current proposals are the optimal solution but instead they may contain individual elements which are suitable to include in a reform package. The preferred solution may therefore be a combination of the published proposals. However, we understand that Ofgem is only able to approve or reject the proposals put forward as they stand and we would therefore welcome guidance on how Ofgem intends to proceed if it is the case that elements from two or more proposals represent the best solution.

The case for reform

We agree that the volatility and unpredictability of the charges generated under the current LRMC approach to setting capacity prices is problematic for network users. This appears to be a function of the assumptions used in the modelling and there may be ways to mitigate these effects. Although the Capacity Weighted Distance (CWD) or postage stamp approaches proposed under 0621 could stabilise charges, enduring stability will depend on the consistency and accuracy of the Forecast Contracted Capacity (FCC).

While stability and predictability in charges is desirable, this is not in itself a justification to move to a CWD or postage stamp model. We note that the CWD approach that is proposed in most of the 0621 modifications is not obligatory under the TAR Code but is merely the required counterfactual. The current approach to setting capacity charges based on marginal costs should be most cost-reflective, whereas the approaches under 0621 are instead cost allocation approaches. We understand that the justification for this is that the network is characterised by spare capacity and therefore a marginal cost approach may no longer be appropriate. However, there may be areas of constraint on the network going forward for which the proposed new approaches do not deliver appropriate price signals. The proposed approaches under 0621 therefore cannot be considered to be more cost-reflective than the current LRMC methodology.

If it is accepted that it is preferable to move to a cost allocation approach, there may be merits in either a postage stamp or CWD model. A postage stamp approach (0621J) may be most consistent with the belief that the network will be characterised by spare capacity in all locations. The CWD approach would retain some locational signals, although it will be important to verify that these signals are sensible in all circumstances (for example, for exit points close to entry points). There does not appear to be a reasonable justification for the using the square root approach in 0621D other than to dampen some of the effect of extended distances in the CWD calculation. If the CWD approach is intended to maintain some geographic element to charges, we cannot understand how it would be logical to distort these signals in this way.

Key elements of the proposals have yet to be determined

All the 0621 modification proposals represent a substantial change to the NTS charging arrangements. However, most of the proposals do not specify some key design elements in the enduring period. 0621B appears to be the only proposal which specifies a complete enduring solution. Without certainty on these design elements it is not possible properly to assess the impact of the changes and understand which is preferable. We consider that a final decision should not be reached on these modification proposals until these design elements have been specified.

Forecast Contracted Capacity

We consider that the use of obligated capacity as the FCC in the interim period may be sensible since it is a transparent and stable value and will lead to predictable and consistent capacity charges. We are concerned that other than 0621B, all proposals rely on National Grid to develop a forecast of FCC in the enduring period. There is currently

no clarity as to how National Grid will forecast the capacity which will be contracted at each entry and exit point or verify that its forecasts are sensible. It may be challenging for National Grid to develop scenarios for contracted capacity as historic behaviour may not be an accurate indication of future bookings (for example, at CCGTs). We are not clear what incentives there will be on National Grid to ensure that its forecasts are as accurate as possible.

Shorthaul tariffs

EPUKI considers that there should be a suitable ongoing incentive to avoid inefficient bypass of the NTS and the current Optional Commodity Charge (OCC) is effective in achieving this. An effective OCC or equivalent is therefore a crucial part of the charging arrangements. EPUKI opposes 0621D on the basis that it would remove the shorthaul arrangements from 2019 and would therefore lead to inefficient outcomes in the operation of the network.

The adoption of a CWD or postage stamp approach could lead to a large increase in capacity charges for offtakes close to entry points compared to the current charging regime. The incentive to bypass the NTS will therefore be greater and the need for an effective shorthaul tariff will increase. Furthermore, if the transmission services revenue recovery charge is expected to be small in the enduring period, a new way of structuring the shorthaul tariff will be required.

We note that all proposals that retain the current shorthaul arrangements in the interim period envisage updating the formula for RPI and including a 60 km distance cap. The justification for these amendments is not clearly made in the draft modification report and, as discussed in our response to UNC0636, such changes need careful consideration. The current shorthaul tariff has remained unchanged for nearly 20 years and will have formed the basis of historic and future investment decisions, which must not be undermined by changes to the formula. We consider that the introduction of a distance cap may help address concerns that the OCC is increasingly being used by routes where there is no realistic possibility of economic bypass of the NTS. However, there are clearly a number of potential options for the future of the OCC in terms of the structure and application of the formula and the distance cap which could be applied. For example, the 0621 proposals are not consistent with those put forward under 0636 and we are not clear how these two modifications may interact in terms of establishing the correct parameters for any amendments to the shorthaul tariff going forward.

Other than 0621B and 0621C, the proposals featuring shorthaul only guarantee to maintain the shorthaul tariff for the interim period until 2021 and only commit to consider the structure and application of the shorthaul tariff beyond that. This provides no assurance that a shorthaul tariff will remain after 2021 or any certainty as to how this will be calculated and applied if all charges are capacity-based. A predictable and transparent charging regime should not leave such a crucial part of the mechanism undecided. We therefore consider that these proposals are deficient and require further development as to the application of shorthaul before the Panel or Ofgem can decide whether they are appropriate.

In respect of the proposals which retain an Optional Commodity Charge on an enduring basis:

- 0621B: This modification retains a similar approach to shorthaul charges to the current regime. This is therefore a predictable approach which continues to provide an appropriate incentive to avoid bypass of the NTS on an enduring basis. For this reason, 0621B is our preferred modification.
- 0621C: If a charging regime without commodity charges is adopted, there may be merit in the approach to shorthaul proposed in 0621C, which will provide for reduced capacity charges at applicable entry and exit points. However, we consider that further analysis of this approach is required to ensure that the formula delivers sensible results for potential shorthaul routes and that it efficiently retains an incentive to avoid system bypass. Further consideration of the application of the Revenue Rebalancing Factor and the rationale for paying Transmission Services Revenue Recovery charges on eligible volumes is also required.

The impact of capacity-based revenue recovery charges

The majority of proposals would move to capacity-based revenue recovery charges in the enduring period. As capacity-based charges cannot be directly passed through in the same way as commodity charges, this will have an impact on the behaviours of market participants and create different pass through strategies. This will include impacts in the wholesale electricity market and capacity auctions. For example, if the reforms result in capacity-only charges and there is a reduced discount for interruptible capacity, lower efficiency generators may face increased costs which they are unable effectively to recover. This might result in worsened economics for these plants and force them to seek improved revenues elsewhere (for example, the capacity market). We therefore consider that a full impact assessment is required to understand the likely impacts across both the gas and electricity systems and whether it is desirable to move to charges based entirely on capacity.

Transition period

0621E contains an extended transition period at exit to reflect the fact that existing CCGTs have already accepted capacity agreements through to September 2022. We agree that it would be preferable to maintain a charging regime which is broadly similar to the current model until then so as not to undermine these bidding decisions. However, we note that as the proposal contains no provision for shorthaul beyond September 2021 the current design of 0621E does not necessarily fulfil its purpose of maintaining the expected structure and level of gas charges until the end of currently contracted capacity agreements.

Implementation: *What lead-time do you wish to see prior to implementation and why? Please specify which Modification if you are highlighting any issues.*

These modifications could lead to substantial changes in charges and this creates significant risk for market participants. For example, a developer of a new CCGT may seek a 15 year fixed price capacity agreement in the T-4 capacity auction in February 2019 and would make assumptions about future gas charges when bidding. It is therefore crucial that there is certainty on the direction of travel for these modifications ahead of this capacity auction. We are unclear how long it will take Ofgem to undertake an Impact Assessment of these proposals, but we consider that Ofgem should at least have reached a 'minded to' decision before the end of 2018 setting out its preferred solution. We also consider that enduring proposals for the shorthaul methodology and Forecast Contracted Capacity should be developed prior to this date to allow developers to bid into the capacity market on an informed basis. EPUKI therefore considers that a large amount of additional work is required before a decision can be reached on these modifications and a programme should be developed to deliver this.

Impacts and Costs: *What analysis, development and ongoing costs would you face?*

All modifications represent a substantial change to the NTS charging arrangements. EPUKI would therefore need to update its internal analysis and modelling and re-educate staff on the structure of NTS gas charges. Some contracts may also need to be updated to reflect the changed structure of charges (eg. removal of commodity charges).

The change in charges associated with the chosen solution could affect investment decisions, including decisions about the remaining lifetime of offtakes such as CCGTs. It is crucial that any reform provides certainty over the scale and structure of charges in the long term. We therefore consider that changes that increase uncertainty (for example, by failing to specify elements of the enduring solution) should be avoided as this could lead to unintended consequences, such as the early closure of offtakes.

Legal Text: *Are you satisfied that the legal text will deliver the intent of the Solution? Please specify which Modification if you are highlighting any issues.*

No comment.

Modification Panel Members have requested that the following questions are addressed:
Please specify which Modification your views relate to.

1. *Do you believe there is specific issues that should be considered by Ofgem's Regulatory Impact Assessment?*

Ofgem requested that the following questions be included as part of the consultation. Panel agreed to include these:

2. *The rationale in the report for having an interim period and using the obligated capacity as the Forecasted Contracted Capacity (FCC) is to avoid significant changes to charges and have a period to understand how booking behaviour changes. How does this compare to having two structural changes to charges (one at the start of the interim period and another at the enduring period)?*
3. *What (if any) consequences do you see from 'interim contracts' being allocated at QSEC and AMSEC auctions in 2019 given the timings of these auctions in the UNC and possible date of Ofgem decision on UNC621? What options are there to deal with these consequences and what impact would these options have?*
4. *Do you consider the proposals to be compliant with relevant legally binding decisions of the European Commission and/or the Agency for the Co-Operation of Energy Regulators?*
5. *In what way do you consider the reference price methodologies proposed (Capacity Weighted Distance (CWD), CWD using square root of distance and Postage Stamp) to be cost reflective and meet the criteria in Article 7 of TAR?*
6. *The proposals have different combinations of specific capacity discounts for storage sites and bilateral interconnection points. In what way do you consider the different combinations facilitate effective competition between gas shippers and gas suppliers?*

See comments above.

Are there any errors or omissions in this Modification Report that you think should be taken into account? *Include details of any impacts/costs to your organisation that are directly related to this.*

No comment.

Please provide below any additional analysis or information to support your representation

No comment.