

By Email

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Representation - UNC Modification 0621, 0621A, 0621B, 0621C, 0621D, 0621E, 0621F, 0621H, 0621J, 0621K, 0621L – Amendments to Gas Transmission Charging Review

Indication of Support

0621J – Support (*preference*)

0621H – Qualified Support

For a number of the proposals there are positives and negatives for certain Relevant Objectives and therefore we do not feel the the standard consultation response template for this representation is appropriate. Therefore, rather than focusing on each proposal individually, our response focuses on each Relevant Objective and the aspects of diferent proposals we feel have a positive or negative impact. For more information on each of the modifications measured against the Relevant Objectives please see the Annex.

Standard Relevant Objectives

a) Efficient and economic operation of the pipe-line system

NTS Optional Charge

We support the principles of the NTS Optional Charge (or “Shorthaul”) in that it should be used to encourage the use of the NTS and avoid inefficient bypass, therefore we agree that the product needs to be updated and using RPI as an inflation factor and a (although somewhat arbitrary) distance cap is an acceptable interim solution. Justification for the 60km distance cap was given by National Grid being that distance where no current Shorthaul users just missed out on the product. Therefore, given that no analysis has been undertaken to ascertain what would be a reasonable distance across which an offtake would be built, we believe that 60km is still a generous distance cap and a shorter one should be considered. It is also worth nothing that the original Shorthaul parameter justification and analysis anticipated a maximum value of 50km.

Because of the expected removal of Transmission (or “TO”) commodity charges in 2021 a replacement solution is needed if the product is to remain part of Transmission Services (it would still be an exemption to Non-Transmission (or “SO”) commodity charges). Therefore, we believe that this is a good time to redevelop the product from scratch to ensure it meets its original principles and is aligned to a new charging methodology, independently of the Gas Transmission Charging Review.

In terms of principles, the product should be reflective of the costs of building and operating an independent pipeline and should be self-limiting. We do not agree that Shorthaul should be used to attract gas to the GB market or help overcome unwanted location signals from the Capacity Weighted Distance (“CWD”) RPM. If Shorthaul is required to be used for either of these points then the underlying RPM is not fit for purpose.

Updating the cost base by RPI and introducing a distance cap during the transitional period results in a positive change for Relevant Objective (a), however we believe there is still some improvement to be made to the product. We believe the removal of the Optional Charge in 0621D has a negative impact on Relevant Objective (a) as it is not unreasonable to assume that it would be economically viable for some users of Shorthaul to build an independent pipeline. Therefore it is likely that removing the product entirely would result in inefficient operation and uneconomical operational of the NTS. In respect to 0621C there is not enough analysis on the proposed solution to make an informed decision, however we are concerned that the methodology proposed could result in discriminatory Shorthaul charges as a result of limitation of CWD (where Shorthaul rates for the same sized loads and distances would be different due to the CWD calculation). We would welcome more time outside of the 0621 process to develop a solution.

c) Efficient discharge of the licensee’s obligation

As per Charging Relevant Objectives section below

d) Securing of effective competition

Reference Price Methodology (RPM)

We do not believe that the current charging methodology (LRMC) is suitable for the charging of the NTS, nor promotes competition. The current LRMC methodology is an investment based model which is more suitable for an expanding network. As this does not represent the current usage of the NTS, which is widely acknowledged to be a more mature network, we do not believe the existing methodology to be suitable for the current and future use of the NTS. Whilst we generally agree that the majority of the NTS is mature, we do regard LNG Entry Points as parts of the network which could expand in the future and therefore the methodology needs to reflect this.

There are numerous inputs required in the current LRMC methodology which when updated result in unpredictable changes. Figure 1 shows the minimum and maximum changes which occur when inputs to the LRMC model are adjusted. The changes to the inputs that were modelled are not unrealistic (e.g. 10% change in revenues or supply and demand) and result in unstable and unpredictable prices. To minimize this instability, the inputs would need to be modified so significantly that the resultant model would no longer be suitable for purpose. The inputs into the Postage Stamp (or “PS”) and CWD model are much simpler – Figure 2 shows how similar changes to the inputs as previously shown for LRMC, result in changes that are consistent across all entry and exit points, which therefore results in more stable and predictable charges.

The PS model requires only two inputs for prices to be calculated – revenue and aggregate Forecasted Contracted Capacity (FCC), whereas the CWD models requires three – revenue, point specific FCC and a distance matrix. There is currently no methodology for calculating the FCC, which is the key input in allocating costs effectively in both the CWD and PS RPMs, and given the anticipated behavioural change to booking capacity because of an RPM change, we have some concerns as to how point specific FCC is going to be accurately forecast. We believe the forecasting of an aggregate FCC value required for the PS RPM is more likely to be accurate and will therefore result in a fairer allocation of costs.

Figure 1

Sensitivity Analysis – LRMC – Analysis Results

Input Adjustment	Range Impact on Entry		Range Impact on Exit	
	Decrease	Increase	Decrease	Increase
Merit Order - Prorated	-64%	2400%	-52%	6400%
Supply and Demand – 10% Decrease	-99%	7900%	-99%	2400%
Supply and Demand -10% Increase	-8%	307%	-94%	12100%
Revenues – 10% Increase	0%	0%	0%	1500%
Revenues – 10% Decrease	0%	0%	-94%	0%
Capacity – 10% Increase	0%	47%	-94%	0%
Capacity – 10% Decrease	-81%	0%	0%	1600%
Merit Order Prorated / Supply and Demand – 10% Increase	-64%	2000%	-52%	6400%
Merit Order Prorated / Supply and Demand – 10% Decrease	-99%	3400%	-52%	6400%
Supply and Demand / Revenue / Capacity – 10% Increase	-93%	7900%	-99%	2400%
Supply and Demand / Revenue / Capacity – 10% Decrease	-11%	253%	-94%	12100%

Figure 2

Sensitivity Analysis – CWD / Postage – Analysis Results

Input Adjustment	Range Impact on Entry	Range Impact on Exit
Revenue – 10% Increase	10%	10%
Revenue – 10% Decrease	-10%	-10%
Capacity – 10% Increase	-9%	-9%
Capacity – 10% Decrease	11%	11%

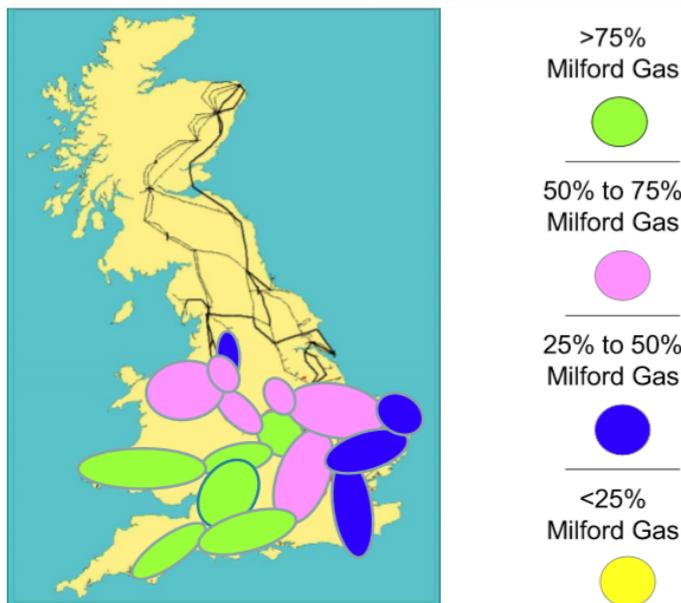
We do not regard the Capacity Weighted Distance or the PS RPMs to be cost reflective (neither do we consider the current LRMC methodology to be cost reflective), however we believe the weighted average distance calculation in the CWD RPM is not a valid location driver, and therefore makes the CWD less suitable compared to PS.

Entry points are currently unlikely to supply all Exit zones on the NTS. This can be seen in Figure 3, which is a heat map showing the maximum penetration of gas from Milford Haven into the NTS (provided as part of UNC Mod 0645). This heat map confirms that gas from Milford Haven can reach the North West and East of the UK in ‘worst case’ summer

conditions, however under no scenario does the gas penetrate above this into the North of the UK. Therefore, using a weighted average distance calculation which considers all exit points from Milford Haven is not reflective of the current (and anticipated future) use of the NTS, distorts prices and does not allocate costs fairly, and therefore cannot be a cost reflective RPM.

Because of this we believe that the PS furthers Relevant Objective (d) and results in prices which are better suited to facilitate competition, as they are not distorted by the weighted average distance calculation, and are therefore not discriminatory.

Figure 3



Treatment of Historical Contracts

We do not believe that historical contracts should be subject to a capacity revenue recovery charge. These contracts were entered into during a previous regime and are widely classed as sunk costs by procurers. We recognise the argument that these contracts were entered knowing that a revenue recovery charge would be applicable, however this charge was in the form of a commodity charge and was only applicable to capacity that was flowed against. It is also worth noting that there was no expectation that the current revenue recovery would be so high, which effectively subsidised the short term products when the system became unconstrained. With LNG being a flexible source of gas supply into GB, with growing importance, we believe applying a revenue recovery charge on all previously bought capacity would have a negative impact on security of supply in the short term due to the additional cost associated with effectively increasing the historical contract price.

One other solution for this would be to use a commodity charge as a revenue recovery charge which is applicable to allocated flows, as proposed in 0621B. However, based on previous discussions with Ofgem we do not believe this to be a solution which would be approved. Similarly the commodity solution for historical contracts proposed in 0621C and 0621E (where a flow based charge, as opposed to capacity charge, is applied to historical

contracts) has the potential to be a suitable solution, however no analysis has been done to understand what the size of such a flow based charge would be, and therefore we have not been able to understand the impact this would have and can't be supported at this time.

We believe the treatment of historical contracts under 0621H furthers the Relevant Objective (d) by not changing the contractual capacity price and ensuring that there is not a distortion of competition against these capacity holdings.

g) Compliance with the Regulation

We do not believe that historical contracts should be included in the FCC and Revenue inputs of the reference price methodology, as proposed under modification 0621L, as this results in a reference price calculation which is not consistent across Entry and Exit. The inclusion of historical contracts in the FCC drives an under collection of revenue on Entry only, and results in a revenue recovery charge which is applied to all capacity bookings, historical and new, which unduly discriminates against historical contracts. Due to this, we do not believe the reference price calculation for Entry to be compliant with EU TAR.

Charging Relevant Objectives

a) The charging methodology results in charges which reflect costs incurred by the licensee

As per Relevant Objective (d) we do not believe that either CWD or PS are entirely cost reflective models (albeit no worse than the current LRMC) as both are designed to recover revenue through allocation of costs. It has been widely agreed (except from our perspective of LNG terminals) that the NTS is no longer expanding with excess capacity on the network. The price control revenue allowance is an aggregate number which reflects investments made in the NTS over the last 40 years (approximately). During this time users of the network have contributed to the development and operations of the NTS and it would be fair to assume that the majority of the network has been paid for. Therefore the use of distance related costs and marginal cost related charges are only relevant where costs on a particular part of the network are still to be recovered. Therefore, given that the price control allowance does not separate out costs within different areas of the network, we believe that the PS model, which sets costs on a uniform basis across all points, must be used as the RPM to ensure that the allocation of costs and revenues is fair across all points. Because of this we believe 0621J furthers Charging Relevant Objective (a) compared to other proposals.

b) The charging methodology takes account of developments in the transportation business

In general, all proposals assume that the network is no longer expanding and therefore the RPM is looking to recover historical costs. Where there is expansion in the future the PARCA process allows for the recovery of costs through auctions and price steps. We have reservations around whether the use of an RPM, which assumes a mature network, aligns with the PARCA process which could result in network investment. The CWD and PS RPMs allocate costs based on historical costs of the network which are not representative of future marginal costs as a result of incremental use. The capacity costs are also significantly

larger (three times) when compared to the current costs which may disincentivise new flexible investment. Therefore using these prices to establish cost associated with buying incremental capacity could result in an over commitment by Users. We believe the period of commitment required under PARCA to acquire capacity would need to be reviewed under any new charging regime.

c) The charging methodology facilitates effective competition

As per Relevant Objective (d).

e) Compliance with the Regulation

As per Relevant Objective (g).

Implementation

Whilst we understand the latest a decision can be made to comply with the EU Tariff Code is 31st May 2019, given the materiality of the changes, we would encourage a decision to be made earlier than this to give industry participants further clarity, especially regarding the Quarterly System Entry Capacity (QSEC) auction in 2019.

We would also welcome a “minded to” decision by Ofgem in late-2018 as part of the impact assessment consultation, to help provide clarity around potential proposal(s) that could be selected.

Impacts and Costs

It is beneficial under all methodologies to purchase only the entry capacity that the User will flow, which is not possible for flexible gas supply sources such as LNG terminals at potentially constrained locations. LNG terminals are a flexible gas supply source for GB as LNG imports are reliant on the economics of the global LNG market and the cost of using the NTS, therefore South Hook Gas seeks to hold adequate entry capacity in the event that full regasification at the terminal is required. We regularly participate in the QSEC auctions to ensure such capacity is secured at the Milford Haven Aggregated System Entry Point (ASEP) as opposed to buying shorter term capacity products. The booking of longer term capacity has always been encouraged by National Grid Gas and allows South Hook Gas to mitigate against the risks of capacity being unavailable. The calculated reserve prices (which show increases up to 300% higher than current) and revenue recovery rates (which are applied to capacity, if applicable) within the methodologies (except 0621B) are likely to have a negative impact on South Hook Gas and do not incentive the use of flexible supply sources going forward.

The exception to the above is proposal 0621B which would be beneficial for South Hook Gas under a number of scenarios. However, we have not supported the proposals for a number of reasons. The first being that Ofgem have previously stated that this does not mirror the policy recommendations in their original Gas Transmission Charging Review policy paper¹, and is unlikely to be accepted. The second reason being that we believe there are still flaws

¹ https://www.ofgem.gov.uk/sites/default/files/docs/2014/12/gtcr_policy_position_0.pdf

in the proposals (i.e. FCC being obligated during the enduring period and continuing to drive an under recovery). We do support the use of a flow based revenue recovery charge during the enduring period as this allows South Hook Gas, and other entry terminals, to remain flexible.

Legal Text

We have not reviewed all the legal text for all proposals.

Modification Panel and Ofgem questions

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

Within the workgroup report Section 10 – Workgroup Recommendation for further analysis and assessment contains a list of topics contributors would like to see part of Ofgem's Regulatory Impact Assessment. Specifically we would like to see;

- a) Whether the new charging methodology aligns with new network investment (i.e. does it represent incremental costs and does it disincentivise investment in new flexible sources)
- b) The impact on NBP liquidity
- c) Attractiveness of GB as a destination for global gas

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)?*

Irrespective of what proposal is implemented there is going to be a significant change in booking behaviour due to the changes in short term discounts and interruptible capacity prices. Therefore, a transitional period is required for National Grid to understand what these behavioural changes are, and what a resultant FCC should be, both on an aggregate and point specific basis. Where there is a forecasting error, all points make a contribution towards the revenue recovery charge, which in some cases will mean that the total costs paid by Users at some points will exceed the original cost allocation from the RPM. This results in certain Users making excessive contributions and cross-subsidises other Users at different points. Incorrectly forecasting the FCC would ultimately result in misallocation of costs and more volatile and unpredictable prices.

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?*

There is uncertainty around whether a fixed or floating price will be applicable for the QSEC and AMSEC 2019 auctions which will impact the booking strategy for shippers, who will be apprehensive of purchasing capacity without knowing which charging methodology is

applicable. We would prefer any auctions which use the old methodology to generate reserve prices to be considered as historical contracts, rather than using the old methodology to generate prices which will change (float) due to the new methodology after allocation.

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?*

As per Relevant Objective (g) we believe all proposals to be compliant except for 0621L due to its Entry Reference Price calculation. However, we have not done a full legal analysis of the proposals.

5. *In what way do you consider the reference price methodologies proposed (Capacity Weighted Distance (CWD), CWD using square root of distance and PS) to be cost reflective and meet the criteria in Article 7 of TAR?*

Article 7(a) – All RPMs allow network users to reproduce the calculation and accurately forecast if the inputs are consistent.

Article 7(b) – All RPMs allocate costs, rather than reflect the costs of using the network, and the PS allows this without distortion of an average distance calculation (which, as previously mentioned, we believe to be a distortive locational driver based on it unfairly discriminating against points which are greater than the average distance).

Article 7(c) – The PS RPM is the only Cost Allocation Assessment less than 10% in the enduring period, as prescribed by EU TAR.

Article 7(d) – This will need to be a consideration for Ofgem in their impact assessment.

Article 7(e) – Due to the uniform prices across the PS RPM it does not result in reference prices which distort cross-border trade as all entry and exit points are on a level playing field. Whether the CWD RPM results in this is a consideration for Ofgem.

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?*

0621/0621E/0621F/0621H/0621L propose a 50% discount to storage as per the EU TAR, with the sole reason being to not double count charges. This has no impact on competition.

0621A/0621B/0621C/0621D/0621J/0621K propose 86% discount based on analysis carried out for 0621A. This analysis argues that the discount reflects the costs and benefits associated with using storage facilities and therefore facilitates competition. We do not believe that the analysis provided proves that the higher discount is cost reflective and leads to a better facilitation of competition. Therefore, we believe it is for Ofgem to decide, as part of their decision, whether this discount is cost reflective and results in wider benefits to the GB system.

0621F proposes a 50% discount for bi-directional interconnectors. Whilst the discount is argued to facilitate competition (in favour of Interconnection Points) we do not agree with the justification comparing IPs to Storage Points, and therefore believe this discount distorts competition and could result in imported gas from an IP being favoured over other GB Entry points.

Errors and Omissions

There is a lack of analysis around the impact of under (or over) recovery in the enduring period. The models make the assumptions that FCC is equal to the anticipated booking scenario, which is unlikely to be the case. Therefore, we could not make an informed decision around the revenue recovery approaches in all proposals. We would have liked to better understand the impact that the revenue recovery approach in 0621C and 0621E for historical contracts. We believe in principle that the flow based approach proposed for the revenue recovery for historical contracts is sound (as it is consistent with the revenue recovery mechanism in which these contracts were entered under), however we were not able to assess the size of these rates and the result impact on the relevant objectives.

There were errors found in the models and analysis during in the consultation period which subsequently impacted our ability to conduct all the required analysis.

We hope this response is of assistance. If you require any further information or wish to discuss any aspects of this response please do not hesitate to contact me via phone (07787 524 566) or email (abates@southhookgas.com).

Yours sincerely

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