

Modification proposal:	Uniform Network Code (UNC) 667: Inclusion and Amendment of the Entry Incremental Capacity Release Net Present Value test in the Uniform Network Code (UNC667)		
Decision:	The Authority ¹ has decided to reject this modification ²		
Target audience:	UNC Panel, Parties to the UNC and other interested parties		
Date of publication:	20 February 2020	Implementation date:	n/a

Background

UNC667 was raised by South Hook Gas ('SHG', 'the Proposer') in October 2018. It seeks to move the Net Present Value ('NPV') test from the Entry Capacity Release Methodology Statement ('the ECR Methodology Statement')³ into the UNC Transportation Principal Document and then to revise the NPV test under the UNC governance process. The ECR Methodology Statement sets out the conditions under which National Grid Gas Plc ('NGG', 'National Grid Gas', 'the Licensee') reserves and releases National Transmission System (NTS) entry capacity, including Incremental Entry Capacity, which is capacity over and above the obligated levels as defined in the NGG's Gas Transporter Licence, Special Conditions ('the Licence', 'NGG's Licence').

Capacity is reserved and released via the Planning and Advanced Reservation of Capacity Agreement ('PARCA') process. A PARCA is a bilateral contract allowing an NTS user to secure entry and/or exit capacity directly from NGG. A PARCA allows the NTS user to reserve capacity while they develop their project, and before they buy that reserved capacity.

As part of the PARCA process, a PARCA applicant requesting additional capacity is required to pass the Incremental Capacity Release NPV test. The NPV test is an economic test defined in the ECR Methodology Statement which compares the NPV of capacity revenues with the Estimated Project Value. The purpose of the NPV test is to provide a sufficient level of assurance that an appropriate portion of costs associated with providing incremental capacity is recovered from the PARCA applicant so that consumers are not exposed to excessive costs.

The modification proposal

UNC667 is seeking to a) change the governance of the NPV test by moving the NPV test from the ECR Methodology Statement⁴ into the UNC Transportation Principal Document, Section B⁵, and; b) to then revise the NPV test under the UNC governance process, to amend the duration for which incremental capacity must be signalled.

SHG said that the NPV methodology, at the time the UNC667 proposal was made, was unclear and unfit for purpose. SHG said that its proposed project at Milford Haven could

¹References to the "Authority", "Ofgem", "we" and "our" are used interchangeably in this document. The Authority refers to GEMA, the Gas and Electricity Markets Authority. The Office of Gas and Electricity Markets (Ofgem) supports GEMA in its day to day work. This decision is made by or on behalf of GEMA.

² This document is notice of the reasons for this decision as required by section 38A of the Gas Act 1986.

³ Version 4.0, effective from 31 July 2017 to 24 July 2019, <https://www.nationalgridgas.com/document/91671/download>. The Licence, rather than the UNC, sets out the requirement for, and governance of, the ECR methodology statement.

⁴ Required by the Licence, Special Condition 9A.7 and 9B.9.

⁵ Accessible here: <https://www.gasgovernance.co.uk/TPD>

not pass the PARCA Phase 1 NPV test without SHG needing to reserve more capacity than it could physically use, and that this would result in revenues to NGG in excess of the Estimated Project Value.

UNC667 proposes that the mechanics of the test should be changed to, among other things: introduce an incremental capacity premium; fix the estimated project cost at the end of PARCA Phase 1, and; adjust the Phase 1 project cost by the Retail Price Index ('RPI') for the second NPV test at the end of PARCA Phase 2. It also proposes that an incremental capacity profile is submitted ahead of the second NPV test at the end of PARCA Phase 2 and that incremental capacity is signalled in a minimum of four separate years over the 8-year PARCA period to ensure a 'sustained incremental signal'.

Interactions with Review of Methodology Statements

When UNC667 was proposed, version 4 of the ECR Methodology Statement was in effect. In July 2019⁶ we approved the revised ECR Methodology Statement (version 5.0⁷).

As part of the 2019 review of the ECR Methodology Statement, in anticipation of the replacement of the Long Run Marginal Cost ('LRMC') methodology to ensure compliance with EU Tariff Code (Regulation 2017/460, 'TAR NC'), certain aspects of the NPV test were revised substantially. Changes have been made to the methodology for calculating the project cost (ie the cost of the investment), which is determined on the basis of the Estimated Project Cost Methodology ('EPCM')⁸. Under Version 5.0 of the ECR Methodology Statement:

- Project cost will be locked in prior to capacity reservation at the end of PARCA Phase 1.
- Before allocation of capacity at the end of PARCA Phase 2, project cost will be adjusted for inflation to provide the final estimated project cost.
- A 'capacity premium'⁹, a requirement to signal incremental capacity in a minimum of four separate years, has been introduced.
- A 'PARCA minimum duration requirement' for any capacity applied for through a PARCA has been introduced. The minimum duration requirement will not be less than 16 quarters, as currently defined in the UNC.

UNC Panel¹⁰ recommendation

On 18 April 2019, the Joint Office issued the UNC667 Draft Modification Report for consultation. Five responses were received; four, including the proposer, in favour, and one against implementation of UNC667.

The respondents who supported implementation of UNC667 generally agreed with the proposer that the NPV test was unfit for purpose and considered that the required user commitment for the release of incremental entry capacity was disproportionate. Three

⁶https://www.ofgem.gov.uk/system/files/docs/2019/07/20190722_decision_to_approve_the_methodologies_1.pdf.

⁷The amended ECR, version 5.0, which entered into force on the 24 July 2019, can be found here: <https://www.nationalgridgas.com/document/128001/download>.

⁸ To apply from the day a new charging methodology is in place.

⁹ A premium can be added where, for the given incremental signal, not enough incremental user revenue is generated at the reserve price. The premium is the lowest price that can be added to the reserve price to allow 50% of the estimated project cost to be recovered.

¹⁰ The UNC Panel is established and constituted from time to time pursuant to and in accordance with the UNC Modification Rules.

respondents supported the insertion of the NPV test into the UNC as they considered that this would ensure network users' flexibility to adapt the test. One respondent expressed concerns with regard to the risks arising from the dual-governance structure, should the NPV test be moved to the UNC and expressed a preference that any changes to the NPV test for the release of incremental capacity are completed as part of the review of the ECR Methodology Statement that took place in 2019.

At the UNC Panel meeting on 20 June 2019, some Panel Members thought that modification proposal UNC667 would better facilitate Relevant Objective (d) (*Securing effective competition between users*) through a more proportionate user commitment requirement. One Panel Member noted that UNC667 would create a different user commitment level for incremental capacity as compared with substitution or use of existing capacity. This Panel Member considered that this may negatively impact Relevant Objective (a) (*Efficient and economic operation of the pipe-line system*). Some Panel Members believed that Relevant Objective (c) (*Efficient discharge of the Licensee's obligations*) is negatively impacted due to a risk of dual governance with the NPV test appearing in the Methodology and in the UNC.

The Panel considered that the concerns around dual governance were outweighed by the potential improvement to competition.

With 10 out of 14 votes in favour, the UNC Panel Members recommended implementation of modification proposal UNC667.

Our decision

We have considered the issues raised by the modification proposal and the Final Modification Report ('FMR') dated 20 June 2019. We have considered and taken into account the responses to the industry consultation on the modification proposal which are attached to the FMR¹¹.

We have concluded that this modification proposal does not better facilitate UNC objective (c), may better facilitate UNC objective (d), and has a neutral impact on the other UNC objectives. We consider that the modification is not consistent with our principal objective and statutory duties.¹²

Reasons for our decision

UNC relevant objectives

(a) Efficient and economic operation of the pipeline system

The proposer considers that implementation of modification proposal UNC667 would reduce potential barriers to gas market investment in Great Britain ('GB'), reducing the incentive for users to pursue private investment options bypassing the NTS; and providing greater assurances in respect of GB security of gas supply. The proposer thinks that investment in private pipelines, if it led to gas bypassing the NTS, could have a negative effect on the operation of the NTS. The proposer considers that this could have knock-on effects on the configuration of the network.

¹¹ UNC modification proposals, modification reports and representations can be viewed on the Joint Office of Gas Transporters website at www.gasgovernance.co.uk

¹² The Authority's statutory duties are wider than matters which the Panel must take into consideration and are detailed mainly in the Gas Act 1986.

The FMR did not provide any analysis of the potential knock-on effects of private investment options on the configuration of the network, nor did it provide evidence as to the efficiency of private investment options. We were therefore unable to assess the impact of the potential negative knock-on effects of private investment on the operation of the NTS.

National Grid Gas identified scenarios under modification proposal UNC667 which could lead to negative impacts on the efficient and economic running of the pipeline system. NGG's analysis showed that should UNC667 be implemented, under certain scenarios, the user commitment requirements for existing capacity or substitution solutions would be higher than the user commitment requirements for funded incremental capacity. National Grid Gas thinks this could incentivise PARCA applicants to connect to constrained parts of the network.

We consider the outcomes of modification proposal UNC667 as identified by NGG to be possible, but unlikely. If PARCA applicants were incentivised to connect to constrained parts of the network however, we believe this could lead to uneconomic outcomes for consumers.

Overall, we do not think that the proposal will have an impact on UNC Relevant objective (a).

(c) Efficient discharge of the Licensee's obligations

UNC667 proposes that signatories of the UNC should be able to propose changes to the rules governing entry incremental capacity release and the price control parameters of the NPV test¹³.

The rules for determining incremental capacity release quantities are defined in NGG's Gas Transporter Licence, Special Conditions, and in the ECR Methodology Statement. Paragraphs 6(a) and 6(c) of Special Condition 9B of the Licence¹⁴ require National Grid Gas to publish the ECR Methodology Statement, which describes the methodology that NGG will use to decide whether to make incremental entry capacity available for sale to shippers and, if so, what quantity of incremental entry capacity to make available. The ECR Methodology Statement must be consistent with NGG's duties under the Gas Act and the Licence¹⁵.

The Proposer and some industry representatives think that the UNC is a better location for the NPV test. They think this will allow for a clear statement of the NPV test and the provision of a more efficient review process. NGG think putting the NPV test in the UNC will lead to legal and regulatory uncertainty arising from dual governance arrangements (as the NPV test will then appear in the UNC and the ECR Methodology Statement). NGG

¹³ Ofgem has a formal role, consistent with the requirement to set a price control for NGG, to set a funding mechanism to allow for NGG to recover the full costs of reinforcement to facilitate the incremental capacity increase. This is achieved through the Generic Revenue Driver Methodology (for the RII0-1 price control period). The NPV test acts as the trigger point to set in motion the calculation of the appropriate funding allowance.

¹⁴ Accessible here: https://epr.ofgem.gov.uk/Content/Documents/National%20Grid%20Gas%20Plc%20-%20Special%20Conditions%20Consolidated%20-%20Current%20Version.pdf?utm_source=ofgem&utm_medium=&utm_term=&utm_content=licencecondition&utm_campaign=epr

¹⁵ There is no mention of the UNC in this paragraph of the Licence.

said that its obligation to release NTS capacity, and the associated allowed revenue implications of doing so, is a matter for the Licence. As such, NGG believes that any rules which may amend, substitute or increase the Licence Baseline Exit capacity¹⁶ should be in the Licence or a document governed by the Licence (eg the ECR Methodology Statement).

We recognise there are other examples of code modifications to move rules into industry codes. However, we do not consider these changes comparable with the move of the NPV test into the Code as proposed by UNC667. The NPV test, which is an integral part of the entry capacity release process, determines price control parameters such as the *NPV test threshold, discount rate, and the period over which the NPV test is calculated*. We consider that these parameters should continue to be governed by the Licence and the ECR Methodology Statement, as they determine the proportion of costs that consumers must bear and will affect NGG's allowed revenue.

Taking all these factors into consideration, we consider the proposal would negatively impact UNC Relevant objective (c).

(d) Securing effective competition between users

UNC667 is seeking to change the governance of the NPV test and to amend the duration for which incremental capacity must be signalled.

The Proposer considers UNC667 will further relevant objective (d) by updating the NPV test to reflect the current market environment and minimising the requirement for shippers to book capacity when signalling incremental capacity. According to the Proposer, UNC667 would further relevant objective (d) by among others 'not artificially limiting access to entry capacity for other shippers'; and 'reducing barriers to entry for gas market investment'.

The Proposer and some respondents consider that industry would benefit from initiating changes to update the entry capacity release processes, reducing the amount of capacity that must be booked and lowering the hurdle for investors wishing to access incremental capacity on entry. This, according to Workgroup participants, could result in additional gas being brought to the market at relevant entry points, meaning a positive impact on competition.

We consider the potential positive impact of the proposal to be less than that considered by the Proposer due to the fact that the 2019 review of, and changes to, the ECR Methodology Statement covered off most of the substantial changes to the NPV test proposed by modification proposal UNC667¹⁷.

We recognise that the 2019 review of the ECR Methodology Statement did not consider one of the issues that UNC667 proposes to change – a lower user commitment requirement than the current UNC requirement to book capacity in 16 quarters¹⁸.

¹⁶ Means the volume of Entry Capacity that the Licensee must offer for sale as of 1 April 2013 as set out in Table 6 of Special Condition 5F (Determination of Incremental Obligated Entry Capacity volumes and the appropriate revenue drivers to apply).

¹⁷ Please see the text under 'The modification proposal', pages 1 to 3.

¹⁸ However, notwithstanding the lack of analysis on the potential positive benefits from lower user commitment, we consider that the material issue is one of regulatory oversight as UNC667 seeks to dilute the current arrangement of direct regulatory oversight by seeking to move the NPV test from the ECR Methodology Statement into the UNC.

However, we note that under the current arrangements, any UNC party can propose a change to the 16-quarter user commitment requirement in the UNC. This could be proposed separately from a proposal to move the NPV test into the UNC which, as set out above, we consider to negatively impact objective (c). We also note that NGG is currently leading on a review of access arrangements, including the rules around user commitment¹⁹.

We therefore consider that while the proposer thinks that UNC667 furthers UNC Relevant objective (d) by reducing the user commitment requirement, this is a matter that industry could consider and propose a further change to address (if appropriate) without needing to move the NPV test into the Code.

Principal objective and other considerations

The proposed change in governance to move all aspects of the NPV test into the UNC conflicts with our principal objective of protecting the interests of existing and future energy consumers. Specifically, moving the NPV test threshold; the discount rate, and; the period over which the NPV test is calculated, into the UNC would not be exercising our functions in a way that protects the interest of existing and future consumers of gas as these three aspects of the NPV test determine how much consumers pay towards new investments.

Consumers bear the costs of the portion of new investment that is not covered by revenues from capacity sold. If the economic test is moved to the UNC then we are concerned there may be a risk of unintended consequences - eg it is possible that changes could be proposed to amend this test and this could expose consumers to higher costs. This is because, once the economic test is passed, NGG is obliged to release the incremental capacity that has been signalled and will also receive an additional funding allowance associated with that investment. The NPV test is therefore a price control matter and is a matter for the Licence (or documents governed by the Licence) rather than, as proposed, a matter where the industry can initiate change.

We note that the NPV test is particularly relevant in the context of the net zero 2050 climate change targets set by the Government, and in the context of the Future Energy Scenarios forecasts of gas demand. We think that we should be able to initiate change to the NPV test, if appropriate, to reflect these and other considerations.

Decision notice

In accordance with Standard Special Condition A11 of the Gas Transporters Licence, the Authority has decided that modification proposal UNC667: 'Inclusion and Amendment of the Entry Incremental Capacity Release Net Present Value test in the Uniform Network Code' should not be made.

David O'Neill
Head of Gas Systems
Energy Systems Transition

Signed on behalf of the Authority and authorised for that purpose

¹⁹ UNC705R: NTS Capacity Access Review.