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EP UK Investments Limited
Berger House
36-38 Berkeley Square
London W1J 5AE

FAO: Alastair Tolley

VPI Immingham LLP
160 Victoria Street
London
SW1E 5LB

FAO: Iwan Hughes

South Hook Gas Company Ltd
Level 28, The Shard
32 London Bridge Street
London SE1 9SG

FAO: Adam Bates

Saltend Cogeneration Company Ltd
Saltend
Hedon Road
Hull HU12 8GA

FAO: Scott Keen

Dear Sirs

NTS Optional Capacity Charge - Opinion

Introduction

1. You have asked us to provide an opinion on the compliance of the NTS Optional Capacity Charge (OCC) with the provisions of Commission Regulation (EU) 2017/460 of 16 March 2017 establishing a network code on harmonised transmission tariff structures for gas (TAR). The OCC is a feature of the following Uniform Network Code (UNC) Modification Proposals (the Modification Proposals):

47 Offices in 20 Countries

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- 0678D - Amendments to Gas Transmission Charging Regime including a Cost based Optional Capacity Charge;
 - 0678G - Amendments to Gas Transmission Charging Regime including a Cost based Optional Capacity Charge;
 - 0678H - Amendments to Gas Transmission Charging Regime (Postage Stamp) including a Cost based Optional Capacity Charge; and
 - 0678J - Amendments to Gas Charging Regime (Postage Stamp) including a Cost based Optional Capacity Charge.
2. As well as addressing the OCC's compliance with TAR, this Report addresses its compliance with Regulation (EC) 715/2009 of 13 July 2009 on conditions for access to the natural gas transmission networks (the Gas Regulation). It should be noted that paragraph 10 of the Preamble to TAR states that TAR is without prejudice to the application of EU and national competition rules.
 3. The Report is confined to the OCC and does not address the compliance of other aspects of the Modification Proposals with the relevant legislation.
 4. The Report addresses Competition Law at a high level but it is not intended as a comprehensive analysis of the OCC, the costs of pipeline construction, transmission system operation, related pricing methodologies or charges to be applied, or disallowed, to OCC Users
 5. This Report is prepared for the benefit of our clients, EP UK Investments Ltd, VPI Immingham LLP, South Hook Gas Company Ltd and Saltend Cogeneration Company Ltd. We have no objection to publication of this Report in connection with the Modification Proposals. However, any other person relying on this Report does so at their own risk, and we disclaim liability for all and any losses that may arise out of such reliance.

The OCC

6. The Modification Proposals propose a new NTS Optional Capacity Charge designed to discourage inefficient bypasses of the NTS. The NTS Optional Capacity Charge is a set of charging arrangements and associated conditions which apply to Users choosing to avail themselves of them. In the context of this report, the term "OCC" refers to the overall arrangement, "OCC charge" is used to refer to the overall NTS Optional Capacity Charge arrangements as described in the Modification Proposals and the OCC service is used to describe the product provided by National Grid Gas (NGG), that is the rights to deliver gas to, and offtake it from, the Entry and Exit Point which are subject to an OCC arrangement, at a given price, subject to certain conditions being met, failing which, standard charges will apply in addition. "OCC capacity" is used to refer to Entry or Exit Capacity which is subject to such an arrangement. "OCC" is used to refer to the arrangements as a whole. This section sets out our understanding of the OCC, and it is upon that understanding that our opinion is based.
7. The OCC is a service which the User may choose as an alternative to standard Energy and Exit Capacity services. Under the terms of the service:

- (subject to transitional provisions) the User must opt for the service annually, specifying the Entry Point and Exit Point to which the OCC will apply with effect from the following Gas Year;
 - the right to deliver and offtake gas are dependent on capacity being held at both the relevant Entry Point and Exit Point;
 - on any day, the gas offtaken at the Exit Point and delivered to the Entry Point must be equal (and no greater than the levels of capacity held by the User at either point);
 - to the extent utilised for the purpose of the OCC service, the standard Exit Capacity and Entry Capacity held by the User is unavailable for use in the standard manner, for delivery or offtake of gas irrespective of its destination or source.
8. Capacity to be utilised in the service is acquired in the standard way, on a long term or short term, daily basis, although where the restrictions applicable to the OCC Service are met, there will be no charge for the capacity. To the extent that the conditions attached to the service are not met in relation to OCC capacity on any particular day, the surplus capacity can be used by the User for other purposes, be it for the purposes of delivering gas for other destinations at the relevant Entry Point or offtaking gas from other sources at the Exit Point, or traded with other Users. In the case of an Entry Point, the standard capacity charge will be applied to such surplus capacity, whether it is used or not. In the case of an Exit Point, the standard capacity rate will apply only where the capacity is used to offtake gas which originates from sources other than the related OCC Entry Point.
9. Storage points are not eligible for the service and neither are Exit Points from the NTS into distribution networks. Aside from Storage Points, all Entry Points are eligible for the service, including Interconnection Points.
10. The OCC charge is designed to reflect the Capacity Charge that would be required to meet the annualised costs of constructing and maintaining a pipeline directly between the relevant Exit Point and Entry Point, carrying the peak flows of gas expected to be offtaken from the Exit Point (the Forecasted Contracted Capacity, or FCC). The FCC is determined by National Grid Gas (NGG) taking into account historic and anticipated flows using a methodology to be incorporated into the UNC. A User opting for an OCC service commits to paying the OCC charge over the course of a year at a rate which varies according to actual usage, with a true-up payment at the end of the year.
11. During the year, the OCC charge is collected through an “NTS Optional Entry Capacity Charge” and an “NTS Optional Exit Capacity Charge”, each charged at the OCC daily rate, being 50% of the OCC charge converted into a daily rate. The NTS Optional Entry Capacity Charge is applied on a daily basis to the amount of Capacity held by the User at the Entry Point which is equal to the “Applicable Quantity”. The Applicable Quantity is whichever of the following is the lowest in respect of the relevant Day:
- The capacity held by the User at the relevant Entry Point
 - The capacity held by the User at the relevant Exit Point
 - The amount of gas imported by the User at the Entry Point
 - The amount of gas offtaken by the User at the Exit Point.

12. The NTS Optional Exit Capacity Charge is applied to the total of the amount of Capacity which corresponds to the total of the Applicable Quantity and the amount of capacity held by the User at the Exit Point in excess of the Applicable Quantity which is not used on the day.
13. Unless the User delivers gas to the Entry Point and offtakes gas from the Exit Point in an amount equal to the FCC on every day of the year, the total of the NTS Optional Exit Capacity Charges and NTS Optional Entry Capacity Charges payable in a year will be less than the OCC charge for the year. The shortfall is recovered through an Annual NTS OCC Fee equal to the amount by which the OCC charge exceeds the total of the NTS Optional Entry and Exit Capacity Charges paid over the year by the User.
14. Non-Transmission Services charges and Transmission Services Revenue Recovery charges will not be levied on the Applicable Quantity or on Exit Capacity where it is used for offtakes of gas which has not been delivered to the relevant Entry Point.

Nature of the OCC

15. We do not have details of the assets which actually connect OCC Exit Points to Entry Points. Our assumption is that by and large they are an integral part of the overall transmission system: It is implicit in the OCC that an OCC Exit Point can receive gas delivered at Entry Points other than the OCC Entry Point, though that need not necessarily be the case. Even where the assets are part of the integrated system, the degree to which they are integrated can vary considerably. At one extreme a pipeline could run direct from the terminal to an Exit Point with very little onward flow into the rest of the system, at the other, an Exit Point could be on a major route from the terminal to the rest of the system. In some cases the Exit Point may be on, or very close to, the main pipeline itself; in other cases there may be a lengthy, dedicated connecting spur.
16. The significance of the types of assets used to support OCC Exit Points is that the nature of the assets and their usage determines whether or not they are, properly speaking, transmission system assets for the purposes of the Gas Regulation. The Gas Regulation defines transmission as "the transport of natural gas through a network, which mainly contains high-pressure pipelines, other than an upstream pipeline network and other than the part of high-pressure pipelines primarily used in the context of local distribution of natural gas, with a view to its delivery to customers, but not including supply." The same definition is used in the Directive 2009/73/EC of 13 July 2009 concerning common rules for the internal market in natural gas. As ACER observes in its *Agency Report - Analysis of the Consultation Document on the Gas Transmission Tariff Structure for Germany* of 13 February 2019, the application of the same Reference Price Methodology [(RPM)] to transmission system operators which are operating both transmission and regional networks, "can lead to a cross-subsidisation effect. In particular, it is possible that the costs of the distribution pipelines are passed to users of IPs [(Interconnection Points)] or vice versa. This can potentially impact the cost reflectivity of the RPM and ultimately result in a distortion of cross border trade."

17. For the sake of simplicity, we have assumed that Exit Points likely to benefit from an OCC service will be receiving transmission services, even when the conditions attached to the OCC are observed (in other words, when they are receiving gas delivered to the relevant OCC Entry Point). Our understanding is that none of the Modification Proposals contemplate the possibility that any the Exit Points are served by NTS infrastructure that is not in actual fact part of a transmission system; they all apply a standard reference price methodology to all Exit and Entry Capacity Points, subject to the OCC. On that basis the OCC, or the entitlement to flow gas under it, should be regarded as a transmission service, within the meaning of TAR Article 4(1). The costs of the service are caused by the cost drivers of both distance and technical or forecasted contracted capacity, and the costs of service are related to the investment in and operation of infrastructure which is part of an asset base which is subject to regulated pricing for use in provision of transmission services. Accordingly, within the context of the Modification Proposals it is reasonable to treat OCC as a transmission tariff within the meaning of TAR.
18. Transmission tariffs may take the form of capacity-based transmission tariffs or commodity-based tariffs. "Capacity" is defined by the Gas Regulation as "the maximum flow, expressed in normal cubic meters per time unit or in energy unit per time unit, to which the network user is entitled in accordance with the provisions of the transport contract." Commodity-based charges are charges for flows of gas levied for the purpose of covering the costs mainly driven by the quantity of the gas flow and related revenue recovery charges.
19. The OCC charge is calculated on an annual basis, by reference to the FCC. Where the applicable conditions are met, it reduces the charges for capacity held at the relevant Entry Exit and/or Exit Point. Those conditions are that the amount of gas offtaken by the User at the Exit Point on a day must be no greater than the amount delivered by the User at the Entry Point on that day and vice versa. Compliance with these conditions excludes the wider use of the integrated system. To the extent that the User is using capacity at an OCC Exit Point to offtake gas sourced from points other than the relevant Entry Point, full Exit Capacity charges will apply to that Exit Capacity, in addition to the OCC charge. In the case of Entry Points, in addition to the OCC charge, full Entry Capacity charges will be payable on any Entry Capacity not being used to deliver gas at the Entry Point for offtake at the relevant Exit Point, whether such capacity is actually used for deliveries to the wider system or not.
20. If the Applicable Quantity on a day is less than the FCC Capacity, the level of the overall OCC Charge is not reduced; it will reduce the NTS Optional Entry Capacity Charge for the day, but increase the Annual NTS OCC Fee by an equal amount. In the case of Exit Capacity, the OCC Charge will be recovered through the Annual NTS OCC Fee, rather than the daily NTS Optional Exit Capacity Charge, where the Exit Capacity is used to offtake gas in excess of the Applicable Quantity, that is to say, from a delivery point other than the relevant OCC Entry Point. The actual level of flows on a day are only determinative of the timing of the OCC charge. If OCC capacity is not used in compliance with the restrictions on any day, the Annual NTS OCC Fee at the end of the year is increased. It follows that the OCC Charge is a Capacity Charge levied for the User's right to use the System subject to the applicable conditions. To the extent the conditions are not complied with, standard Capacity Charges apply.
21. The Gas Regulation distinguishes between "firm capacity" which is "capacity contractually guaranteed as uninterrupted by the transmission system operator" and

“interruptible capacity”, “which may be interrupted by the transmission system operator in accordance with the conditions stipulated in the transport contract.” As NGG does not have any rights to interrupt the use of OCC capacity, it falls into the firm capacity category.

22. Only in the highly improbable event that on every day in a year the User offtakes an amount equal to the FCC at the Exit Point and delivers an equal or greater amount at the Entry Point would the charges for Entry and Exit Capacity subject to an OCC arrangement be equal. In any other circumstance there will be variances between the amount of Capacity held at the Entry and/or Exit Points and the level of capacity held within the FCC (but above the Applicable Quantity), with the result that the overall charges for Entry and Exit Capacity will be determined separately from each other, notwithstanding that one element of the overall charges, the OCC charge, is common to them both. Consequently, taken as a whole, having regard to the charges that apply when the conditions associated with the OCC are not met, the Capacity Charges for Entry and Exit Points subject to the OCC will be calculated, at least in part, by reference to the standard reference price methodology, which applies separately to each Exit and Entry Point.
23. The OCC offers an alternative to the standard tariffs for Users who are able to comply with the OCC conditions as regards the localised point to point delivery of gas. It will only be attractive to Users who are able to secure dependable supplies of gas at a terminal in relatively close proximity to the relevant Exit Point. NGG's analysis indicates that in practice the OCC will only be attractive for Users serving Large Customers which are directly connected to the NTS and within 30km of an Entry Point. It indicates that currently a total of 17 Exit Points would benefit. Used efficiently, it will enable the User to enjoy lower prices than would be the case if the standard capacity charges applied. On the other hand, if a User did not comply with the conditions attached to the Service, it could end up paying more for the capacity at the relevant Exit and Entry Point than if it simply booked standard Exit and Entry Capacity.
24. NGG's estimate as to the difference in revenue recovery for the 17 Exit Points with an without the OCC (Modification Proposal 678 G, Appendix 3, Table 2) suggests that on average the NTS Optional Entry Capacity Charge would be 9 times lower than the proposed standard Entry Charges, and the NTS Optional Entry Capacity Charge would be 4 times lower than the proposed standard Exit Capacity Charge. In a number of cases, though, due to longstanding Entry Capacity bookings, the NTS Optional Entry Capacity Charge will be higher than the User's weighted average price of Entry Capacity charges.
25. The OCC is a charge which applies in return for the User accepting the application of restrictive conditions to the use of standard capacity. Should the User not wish to abide by those restrictions, it may use the capacity in the standard manner, and pay the standard price, in addition to the OCC charge. It is virtually inevitable that the User will not be able to meet the conditions throughout the year. In our view, therefore, the OCC should be regarded, not as a separate tariff for a different category of capacity, but as part of the overall charge for capacity at relevant Entry and Exit Points, which apply where the restrictions on its use are met.

System Conditions

26. It is not possible to offer a complete compliance assessment of the OCC in the absence of details without an understanding of prevailing and likely system conditions at prospective OCC Entry and Exit Points. There is little or no information in the Modification Proposals on system conditions. In its discussion of the amounts of “obligated or “baseline” capacity that NGG is obliged to make available in its decision of 20 December 2018 on Modification Proposal 621, Ofgem indicated that in most cases obligated capacity values significantly exceed likely capacity bookings and actual flows. Our understanding is that, by and large, there is an excess of capacity available at Entry Points. It is not necessary to book capacity long in advance to be confident of being able to acquire it.
27. As regards Exit Points, the possibility of new local demand being introduced is more likely to incentivise Users to book capacity in advance of the day, especially if there is a possible demand for gas at the relevant Exit Point throughout the year. However, in contrast to OCC Entry Points, we anticipate that it would be difficult for NGG to sell Exit Capacity separately for use free of OCC conditions at the same time as selling OCC capacity for the same Exit Point. The connection equipment at the relevant Exit Point is unlikely to be sized so as to enable the offtake of significantly more gas on a day than the OCC capacity booked for the site.

The Gas Regulation

28. Article 13 of the Gas Regulation stipulates a series of potentially conflicting requirements as regards tariffs for use of the transmission system.

Tariffs, or the methodologies used to calculate them, shall be applied in a non-discriminatory manner.

Tariffs, or the methodologies used to calculate them, shall facilitate efficient gas trade and competition, while at the same time avoiding cross-subsidies between network users ...

Tariffs for network users shall be non-discriminatory and set separately for every entry point into or exit point out of the transmission system.

Member States shall ensure that, after a transitional period, network charges shall not be calculated on the basis of contract paths.

Tariffs for network access shall neither restrict market liquidity nor distort trade across borders of different transmission systems.

29. Leaving aside the question of Exit Points for Storage and connected transportation systems, the OCC can be applied to any combination of Entry and Exit Points on the system. It will result in cheaper overall prices for certain Exit Points than would otherwise have been the case, but only through the application of a generally applicable, standard methodology. The purpose of the OCC is to provide a counterbalance to the cross-subsidy that would otherwise occur between Exit Points close to Entry Points and those which are more distant, and reliant on the wider system.
30. The purpose of the OCC then is to reduce undue discrimination against the users of OCC who would pay disproportionately high costs under the Capacity Weighted

Distance approach of Modification Proposals 687D and 687G, and the Postage Stamp approach of Modification Proposals 687H and 687J. In each case it mollifies the reference price methodology, to avoid extreme cross subsidies between one set of users and another.

31. The ability of Users to relax the OCC conditions and revert to using their capacity free of restrictions could be regarded as giving Users free optionality over standard capacity free of restrictions. However, as noted above, in an unconstrained system as regards entry all Users have this free optionality provided they are willing to delay acquiring entry capacity until they know whether they need it. As regards exit, NGG's commitment to make capacity available on a point to point basis is, we understand, likely to preclude it making capacity available to the same Exit Point on an unconditional basis. Realistically, there is no competition for that Exit Capacity free of restrictions, so the option of relaxing the conditions has no value extrinsic to the OCC charge itself. In the event that the capacity is used free of restriction, it is paid for (in addition to the OCC charge) through the standard Exit Capacity Charge.
32. As indicated above, the OCC should not be regarded as a separate tariff for a different category of capacity, but as part of the overall charge for capacity at relevant Entry and Exit Points which apply to Users willing to accept OCC conditions being applied to that capacity. It is part of a larger overall scheme for capacity charges. Variances between the amount of Capacity held at the Entry and/or Exit Points and the level of capacity held within the FCC (but above the Applicable Quantity) result in the overall charges for Entry and Exit Capacity at the relevant Entry and Exit Points being determined separately from each other. Notwithstanding the existence of the OCC charge as one element of the overall charges common to both points, the reference price used to set the capacity-based transmission for a firm capacity product with a duration of one year is established separately for Entry and Exit Point. Consequently, even though the OCC charge itself is applied equally to the relevant Exit and Entry Points, the overall requirement of the Gas Regulation that Tariffs for network users shall be set separately for every Entry and Exit Point is satisfied.
33. In case of any doubt as to whether the OCC is a tariff set separately for Entry and Exit Points in breach of Article 13.2 of the Regulation, the purpose of that requirement should be borne in mind. Paragraph 19 of the Preamble to the Gas Regulation makes the objective clear.

To enhance competition through liquid wholesale markets for gas, it is vital that gas can be traded independently of its location in the system. The only way to do this is to give network users the freedom to book entry and exit capacity independently, thereby creating gas transport through zones instead of along contractual paths.... Tariffs should not be dependent on the transport route. The tariff set for one or more entry points should therefore not be related to the tariff set for one or more exit points, and vice versa.

34. The objective of setting prices separately for Entry and Exit Points is to ensure that gas can be traded independently of its location in the system. Thanks to the ability of the User to disapply the OCC conditions at any time, it provides no impediment to the trading of gas or, for that matter, capacity, and does not restrict market liquidity. In that respect, the OCC is similar to the current NTS Optional Commodity Charge, a tariff which has never been challenged as being non-compliant with the Regulation. It provides a resolution to potentially extreme discriminatory pricing against sites in close

proximity to terminals, whilst avoiding any restrictions that curtail the participation of OCC users in the wholesale gas markets, where it is a profitable alternative to delivering gas to and from OCC Exit and Entry Points.

35. Notwithstanding the OCC conditions, the delivery and offtake of gas is not bound by a contract path; an OCC user is free at any time to take a different route, provided he pays for the wider system capacity used in doing so. As required by Article 13.1, tariffs for network access incorporating an OCC charge do not restrict market liquidity and, consequently, there would appear to be no adverse impact on potential imports through interconnectors. If anything, the OCC improves the prospects of gas imported to the UK via an interconnector to large consumers in the vicinity of the UK delivery point and taking advantage of an OCC charge.

TAR - Reference Price Methodology

36. Article 6 of TAR requires reference prices to be derived from a reference price methodology set or approved by the national regulatory authority. A reference price is defined as “the price for a capacity product for firm capacity with a duration of one year, which is applicable at entry and exit points and which is used to set capacity-based transmission tariff”. The FCC methodology is used to establish the OCC Charge in the case of Modification Proposals 687D, 687G, 687H and 687J, and, in the case of Modification Proposals 687D and 687G, it is also instrumental in the establishment of the Capacity Weighted Distance methodology. Either way, it is part of the reference price methodology used to establish the overall charges at Entry Exit points that are subject to an OCC arrangement, as regards Users of the OCC service. Consequently, it appears to us that the FCC methodology itself should be subject to Ofgem approval, either under the terms of NGG’s licence or pursuant to an approval process under the UNC.
37. Implicitly, Ofgem’s approval of the Modification Proposal includes approval of the initial draft of the FCC methodology. Modification Proposals 687D and 687G propose that any such revision is to take effect on the date specified by NGG unless Ofgem (upon application by any Shipper or Distribution Network Operator within one month of the notice) issues a direction under Standard Special Condition A11(18) of National Grid’s Licence that the change should not be made. Modification Proposals 678 H and 678J include a more formalised consultation process, but ultimately rely on the same dispute mechanism.
38. Under Standard Special Condition A11(18), where a provision of the UNC requires that, in circumstances specified in the provision, a determination by NGG should be such as is calculated to facilitate the achievement of the relevant objectives, any question arising thereunder as to whether the licensee has complied with that requirement shall be determined by Ofgem. Strictly speaking, the legal text referring to this process should refer to the relevant objectives, but by and large it could be said that under the Modification Proposals the FCC and revisions to it are subject to regulatory approval, subject to a dispute arising between NGG and on or more Users over its contents. However, to remove any doubt about possible compliance with TAR Article 6 in the absence of a User disputing proposed any changes, it would be preferable to incorporate a formal approval process for the FCC methodology into NGG’s licence.

39. Beyond complying with the Regulation, Article 7 of TAR requires the reference price methodology to aim at (as Ofgem puts it in its decision letter on Modification Proposal 621):
- Reproducibility – network users should know the methodology to derive tariffs and should be able to reproduce the tariff calculations;
 - Cost-reflectivity – tariffs should reflect the costs incurred by the TSO (transmission system operator);
 - Non-discrimination – to the extent possible, NRAs (national regulatory authorities) should avoid cross-subsidies where some network users pay for others;
 - Volume risk management – this is to ensure that significant volume risk is not assigned to final consumers;
 - Non-distortion of cross border trade – the RPM (reference price methodology) should ensure non-distortive economic signals for cross-border trade.
40. The incorporation of the FCC and the OCC into the overall pricing methodology for Entry and Exit Capacity is compatible with the first of these objectives. It improves the cost-reflectivity of the Capacity Weighted Distance methodology and consequently is less discriminatory towards Exit Points which are close enough to Entry Points to benefit from the OCC. As discussed above in the context of Article 14.2 of the Gas Regulation, there appears to be no possible distortion of cross-border trade. Finally, consumers benefitting from the OCC are not exposed to volume risks associated with point to point transmission, because the User may, whenever it wishes, relax the OCC conditions and source or dispose of gas elsewhere in the system. The modification of the Capacity Weighted Distance or Postage Stamp methodology by incorporation of the OCC results in an improvement in the realisation of the aims of Article 7 over those methodologies unmollified by the OCC mechanism.

TAR - Tariffs

41. Article 4 deals specifically with transmission tariffs, specifying the transmission services to which they apply and the extent to which commodity tariffs may be applied.
42. As required by Article 4.2 the charges for capacity subject to an OCC arrangement are transmission tariffs set in a manner as to take into account the conditions for firm capacity products. The charges are predicated on firm capacity rights either subject to, or free from, the OCC conditions, at the User's option.
43. The OCC is a capacity charge as required by Article 4.3. Although the daily NTS Optional Entry and Exit Capacity Charges may vary depending on the use of the capacity, the annual payment for the OCC service is unaffected. As regards the use of standard capacity to the extent that the OCC conditions are not met, standard Entry Charges are applied irrespective of whether or not the surplus capacity is used to deliver gas for other purposes. Exit Capacity used free of the standard restrictions will attract the full Exit Capacity charge to the extent that it is utilised to deliver gas from other sources, but the charge is the same as the daily Capacity charge that would apply to a level of capacity equal to that volume, and, in the context of the OCC as a whole, it would be better regarded as a charge for exercising rights to access wider system capacity rather than a Commodity Charge. The Exit Capacity charge is recovering costs associated with the provision of that wider capacity rather than costs

related to specific flows, which are covered by the Commodity Charge in the usual way.

44. Article 4(2) provides that “transmission tariffs may be set in a manner as to take into account the conditions for firm capacity products”. The OCC charges only apply where the User complies with the OCC restrictions to capacity covered by the OCC. Where the User elects not to comply with those conditions, standard capacity charges apply, in addition to the OCC charge.
45. ACER’s [Report on the conditionalities stipulated in contracts for standard capacity products for firm capacity](#) considers the sorts of conditions that can be attached to firm capacity. It notes that such conditionalities may involve Users not being allowed to book Entry and Exit Capacities independently from one another, or facing restrictions on freely flowing gas from any Entry to any Exit point. It observes that conditionalities also exist when “network users can choose not to use the freely allocable firm capacity and commit to a more restrictive contract in exchange for discounts. In this case, network users are incentivised by discounts to limit the use of freely allocable products in a given entry-exit system.” In ACER’s view, “despite the differentiation used in the current terminology, the outcomes of conditionalities either imposed *ex-ante* in contracts, or chosen by network users in exchange for discounts, lead to similar outcomes.”
46. ACER argues that the conditionalities limit the access to the full entry-exit system, and deviate from the underlying gas market design foreseen by the Gas Directive and the Gas Regulation, in terms of full network access and access to greater liquidity. However, it states that “the legislation is silent however, on whether other products that have a ‘mixed’ character could be introduced as stand-alone products next to the (freely allocable) firm and interruptible products, or whether such products may be detrimental to the integration of Union’s gas markets.” ACER recognises that conditionalities are permissible under the term of TAR and the Regulation. In fact it appears to go so far as to suggest that such conditions may be permissible even where they are detrimental to EU market integration. Whether or not that latter view is correct is irrelevant as far as the OCC is concerned. As discussed above, the User’s ability to disapply the OCC conditions means that there is no such detrimental impact.
47. The conditional products discussed in ACER’s report include shorthaul products. It describes these as point-to-point services offered with a distance criterion set for the provision of the service, requiring linked entries and exits not to exceed a maximum distance. Typically, the User does not have access to the virtual trading point. Though in Great Britain, ACER notes, as regards the NTS Optional Commodity Charge, if the User pays the full price of the firm capacity, it can access Great Britain’s virtual trading point, that is to say the NBP. This statement is no less true of the OCC. The User is free to elect not to be bound by the conditions, in which event capacity used to access the NBP is charged at the full standard rates, in addition to the OCC charge.
48. Although ACER appears to accept that the use of conditionalities may be permissible, it declines to give a clear-cut answer as to whether conditionalities should be removed, suggesting further country-based analysis. At present that responsibility falls to Ofgem as national regulatory authority. For the reasons stated above, there are good grounds for it to conclude that the OCC is compliant with the requirements of the Gas Regulation and TAR.

TAR - Non-Transmission Services charges and Transmission Services Revenue Recovery charges

49. Article 4.4 of TAR requires non-transmission services revenue to be recovered by non-transmission tariffs applicable to given non-transmission services. Non-transmission tariffs are required to be “cost-reflective, non-discriminatory, objective and transparent” and “charged to the beneficiaries of a given non-transmission service with the aim of minimising cross-subsidisation”. Where the national regulator is of the view that non-transmission service benefits all network users, “the costs for such service shall be recovered from all network users.”
50. The Modification Proposals indicate that charges currently aimed at collecting the SO Revenue are, in the main, charges for non-transmission services. Waters Wye Associates’ paper of 15 February 2018 in connection with Modification Proposal 621 [Allocation of the OCC charge for SO services](#) argues that to the extent that OCC conditions apply, with the result that the service is analogous to that which could be provided by a direct pipeline by-passing the transmission system, the costs of non-transmission services should not be borne by OCC Users. To the extent that non-transmission services are indeed of no benefit OCC Users, it would be consistent with Article 4.4 not to levy such charges on them. Charging OCC users for services that do not benefit them would amount to a failure to comply with Article 4.4(b). It should be noted though that the regulator has a wide discretion to determine whether or not particular non-transmission service benefit all network users.
51. In the context of Ofgem’s assessment of whether or not particular non-transmission services benefit OCC Users, and the extent to which they should pay non-transmission charges, it is worth noting the proposed treatment of general Non-Transmission Services Entry and Exit Charges under the Modification Proposals. These charges will be applied to OCC Users at the Exit Point to the extent they access the wider system to source gas. As regards the Entry Point, an OCC User will incur these charges if it has the right to deliver gas to the NBP, by virtue of not using the Entry Capacity for the delivery of gas offtaken at the relevant Exit Point, whether it avails itself of that right or not. This appears to be a reasonable compromise as regards the attribution of wider system costs to Users who are primarily using a confined, localised element of it.
52. Transmission Services Revenue Recovery charges are treated in the same way. It is not appropriate for OCC capacity used for restricted purposes to be subject to revenue recovery charges (or to benefit from such charges where negative) which arise due to variances between expected and actual use of the wider system. Users will, though, bear a share of the Transmission Services Revenue Recovery charges, to the extent that the OCC conditions are disapplied and OCC capacity is used to access the wider system. The OCC charge itself, it is equivalent to the annualised cost of building and maintaining a bypass pipeline and it is applied irrespective of whether the pipeline is used in line with the FCC or not. Consequently, as regards there is no possibility of an over or under-recovery of OCC charges needing to be addressed by a revenue recovery charge applying specifically to OCC Users.

TAR - Non-Consumer Exit Points

53. It is proposed that the OCC shall only be available for Exit Points which are Supply Points for consumers connected to the NTS. TAR explicitly provides for different treatment of Storage Points and other Exit or Entry Points. Paragraph (4) of the Preamble states:

Applying a discount at entry points from or exit points to storage facilities in cases where storage facilities are used to transport gas between directly connected systems would benefit these network users compared to other network users booking capacity products without a discount at interconnection points or using storage facilities to transport gas within the same system. This Regulation should introduce mechanisms to avoid such discrimination.

Specific rules for Storage are set out at Article 9(1) of TAR, and discounts to transmission tariffs for a Storage Point are subject to individual assessment. They are therefore not eligible for the application of a generic OCC.

54. Leaving aside the specific provisions of TAR, Storage is also unsuitable for the OCC in that delivery of gas to storage is inherently for the purpose of its use in connection with the wider system. Gas delivered to storage in compliance with the OCC conditions on one day could be used free of those conditions the next. It is incompatible with the core restrictions attached to the OCC service.
55. TAR is also unsuitable for application to other Exit Points, such as Exit Points to Distribution Networks. Capacity at such points is held by the Distribution Network Operator, which does not itself procure the gas. The gas delivered to a Distribution Network has, in contractual terms, been acquired by Users from a variety of Entry Points, and so inherently is making use of the wider system in a way which means that the conditions applicable to the OCC cannot possibly be met. Making the OCC available to Distribution Networks would potentially fatally undermine both the Capacity Weighted Distance and Postage Stamp reference price methodologies.

Competition Law

56. Recital (10) of TAR makes it clear that TAR is without prejudice to the application of EU (and national) Competition law and, in particular, Articles 101 and 102 TFEU. Since UK Competition law currently mirrors EU law, it is only necessary to consider EU law.
57. Article 101 concerns agreements which restrict or distort competition. The OCC has been proposed as a mechanism to allow NGG to recover its allowed revenues in a manner which reduces the more extreme examples of cross-subsidy between Users. It does not impose any restrictions on either NGG or Users in the exercise of their commercial discretion; rather it increases the options available to Users. Accordingly there is nothing to suggest that modification of the UNC to incorporate the OCC would constitute an agreement or concerted practice which has the object or effect of preventing, restricting or distorting the internal market.
58. Article 102 concerns abuses of a dominant position. Given NGG's position as regards the gas grid, it is likely that NGG would be regarded as holding a dominant position in the market for the provision of integrated transmission system services. The question

is, therefore, whether there is any basis for considering that establishment of the OCC could amount to an abuse of that dominant position. In principle, abuses are typically exclusionary of competitors or exploitative of customers. NGG does not have competitors in the market for the operation of the grid. It is unlikely therefore that NGG could be guilty of an exclusionary abuse. However, it might be suggested that, by introducing the OCC, NGG is entering another market, which would be the market for the transport of gas over relatively short distances, between a single entry point and a single exit point.

59. Assuming, for the moment, that such a market (or local markets) actually exists, which is debatable, the question arises whether the OCC could be seen as exclusionary in effect. Given the manner in which the OCC charge is set, i.e. by reference to the costs involved in constructing and maintaining the (equivalent) independent pipeline, it is difficult to see how the OCC could have an exclusionary effect. It is merely providing an alternative service tailored to the particular local need at an appropriate price, thereby increasing competition.
60. The final question is whether the OCC could be regarded as exploitative of customers. Again, however, the OCC merely expands customers' options. The more tailored service is more appropriate to the particular situation addressed by the OCC, and offers savings to customers in comparison with general transmission tariffs. It also enables customers to use the wider services provided by NGG whenever they are required. Customers remain free to choose to arrange for the provision of services substitutable with those provided by the OCC (but without potential access to the wider system) by using an independent pipeline. It is difficult to see how the OCC could be regarded as exploitative. On this basis, it is unlikely that the establishment of the OCC, in principle, could be regarded an abuse of the dominant position of NGG.
61. It is important to note that EU Competition Law includes laws dealing with State aid. There appears to be nothing in the design of the OCC to suggest that State aid laws would be infringed.

Conclusion

62. The OCC is a pragmatic and proportionate solution to the more extreme examples of cross-subsidisation which would otherwise arise from the application of the Capacity Weighted Distance and Postage Stamp reference price methodologies advocated by the Modification Proposals. Crucially, it avoids restricting the use of capacity for other purposes and so has no adverse impact on the integration of the EU wholesale gas market.
63. In our view, the OCC is compliant with TAR, subject only to the following provisos:
 - NGG's licence being modified so that the FCC and revisions to it are subject to approval by Ofgem, without a User having to raise a dispute under the UNC;
 - Ofgem satisfying itself that the proposed treatment of the cost of non-transmission services is a fair reflection of the extent to which OCC Users benefit from such services, or not, depending on the extent to which they comply with the conditions applicable to the OCC service.

64. Moreover, on the basis of the information available to us, there is no reason to suppose that adoption of the OCC would entail any breach of the Gas Regulation or any overarching requirements of Competition Law.

Yours faithfully

A handwritten signature in blue ink, appearing to read 'P. Brennan', with a long horizontal flourish extending to the right.

Paul Brennan
For and on behalf of Squire Patton Boggs (UK) LLP
8th May 2019