

Representation - Modification UNC 0790 (Urgent)

Introduction of a Transmission Services Entry Flow Charge

Responses invited by: 5pm on 06 December 2021

To: enquiries@gasgovernance.co.uk

Please note submission of your representation confirms your consent for publication/circulation.

Representative:	Donatella Anna Ranco
Organisation:	Eni Global Energy Markets Spa
Date of Representation:	06/12/2021
Support or oppose implementation?	Oppose
Relevant Objective:	d) Negative
Relevant Charging Methodology Objective:	aa) Negative c) Negative

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

Eni Global Energy Markets (EGEM) opposes MOD790 because of the following reasons:

- The governance of the process is detrimental to market confidence. The proposal presented by National Grid, if approved, will drastically change the charging methodology without giving market participants the opportunity to properly examine, understand and discuss the implications of such a reform.
- The proposal is not compliant with the UK Tariff Network Code (our below-described analysis is confirmed by the attached leading counsel's Opinion)
- National Grid failed to demonstrate the proposal is needed in order to address the stated objectives. In particular:
 - The lack of stability and predictability of the Reference Price for Entry Capacity is not caused by Existing Contracts but by the low level of forecast accuracy that National Grid performed in relation to Forecasted Contracted Capacity (FCC) for Gas Year 2020/21
 - The exclusion of Existing Contracts from the calculation of the Reference Price was extensively discussed in the process that led to the adoption of the current methodology and it was supported by National Grid and Ofgem
 - The existence of differentials in revenue recovery levels and capacity charges between Existing Contracts and other capacity users was already well known and analysed by National Grid, Baringa and Ofgem when the

current regime was approved and implemented. The differentials have not changed materially in the meantime.

- The price differential for capacity between Existing Contracts and other users does not undermine competition, as demonstrated by Baringa in 2019 and by Frontier Economics in the Impact Assessment on Modification Proposal 790 in 2021
- The Frontier Economics distributional analysis is flawed and not a relevant criterion for approving implementation of the Proposal.

Implementation: *What lead-time do you wish to see prior to implementation and why?*

We do not believe that this Mod should be implemented for the reasons explained in the summary above and in the “additional comments” box below.

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

See below our answer in the additional comments box.

Legal Text: *Are you satisfied that the legal text will deliver the intent of the Solution?*

We do not believe that this Mod should be implemented for the reasons explained in the summary above and in the “additional comments” box below.

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

The Mod is not compliant with the UK Tariff Network Code as further detailed in the “additional comments” box below.

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

We welcome this opportunity to provide our comments and views to the MOD 0790 proposed by National Grid.

As a general remark, we would like to highlight our concerns on the way this process is being carried out. The proposal presented by National Grid, if approved, will have significant implications for the gas portfolios of individual shippers and we are of the opinion that an adequate modification process cannot be carried out in such a short period of time with the market participants only having limited opportunity to properly understand and discuss the implications of such a reform. Given the significance of the changes being proposed, we believe that a consultation period of at least two months, as provided for under Article 26 of the UK TAR NC, would have been much more appropriate. We have significant concerns about the way this reform is being carried out and we believe that this is very detrimental to market confidence. Our concerns are further exacerbated given that a major review of the Gas Transmission Charging Regime was implemented only one year ago, on 1 October 2020; it took several years to conclude this thorough Charging Review. It is not clear why another significant change has been proposed now so soon after the previous review and in the absence of any changes in circumstances since the last change (see below).

The above is further exacerbated by the timing of publication of the final impact assessment. In fact, providing the final impact study just seven days (28/11) before the deadline for a consultation with such an impact is inappropriate, as it compounds the inadequate time for accurate and detailed analysis even more.

Regarding the merit of the proposal, we believe that there are major concerns with regards to (i) the compliance with the UK Tariff Network Code and (ii) the objectives that it tries to achieve.

1. The proposal is not compliant with the UK Tariff Network Code

In its proposal, National Grid states that the new Entry Flow Charge is compliant with article 4(3)(b) of the UK Tariff Network Code. However, by reading the above-mentioned article in combination with other relevant articles of the TAR NC, it is clear that there are major compliance issues.

In particular, article 4(3)(b) allows the use of a commodity-based charge only under specific circumstances as an exception to the main rule by which *“The transmission services revenue shall be recovered by capacity-based transmission tariff”* (article 4(3)). In this framework, one of the criteria to be fulfilled under article 4(3)(b) is that the relevant commodity-based charge is *“levied for the purpose of managing under- and over-recovery”*.

The concept of “under- and over-recovery” is clearly defined under article 18 of the TAR NC which states the following:

“1. The under- or over-recovery of the transmission services revenue shall be equal to:

RA – R

Where: RA is the actually obtained revenue related to the provision of transmission services;

R is the transmission services revenue.

The values of RA and R shall be attributed to the same tariff period [...]

2. Where the difference calculated in accordance with paragraph 1 is positive, it shall indicate an over-recovery of the transmission services revenue. Where such difference is negative, it shall indicate an under-recovery of the transmission services revenue.”

The above definition leaves no room for interpretation on the fact that an under- (or over-) recovery is the difference between the transmission service revenue and the **actually obtained** revenue. This clearly means that this is an ex-post calculation based on what has been actually collected by the relevant TSO in a specific tariff period.

On the contrary, the proposal presented by National Grid aims at **artificially** creating an **ex-ante expected** under-recovery which will never materialise in practice. Specifically, in order to create this artificial and ex-ante under-recovery, it is proposed to calculate the Entry Capacity Reference Price in an abstract way, without taking into consideration the presence of Existing Contracts’ fixed tariffs (and the related revenues) when calculating the Entry Capacity Reference Price. This is clearly described on page 20 of MOD 0790 where it is stated that *it is proposed that the determination of the Transmission Services Entry Capacity Reference Price for a Gas Year (in principle, the quantity of entry revenue to be collected (£) over this period divided by the quantity of entry capacity (kWh) expected to be booked over this period) is revised as follows:*

Component	Current Method	Proposed Method
Quantity of Revenue (£)	Transmission Services Allowed Revenue at Entry <i>minus revenue from Existing Contracts</i>	Transmission Services Allowed Revenue at Entry
Quantity of Capacity (kWh)	Current Forecast Contracted Capacity (Entry) <i>minus Existing Contract capacity</i>	Proposed Forecast Contracted Capacity (Entry)

By including Existing Contracts capacity and revenues in the calculation of the capacity reserve price, NG is now proposing to do exactly what it advised against when it proposed the current methodology: “The alternative approach of inclusion of capacity already booked and revenue levels already ‘set’ via Existing Contracts in the CWD RPM effectively ‘double counts’ any capacity and revenue for the relevant Entry Points and would have the consequence of setting Reference Prices at Entry Points too low to recover the target revenue.”¹ As noted below (page 7 of this document) Ofgem also stated that it was not appropriate to include Existing Contracts in the calculation because the booked capacity and associated revenues are already known.

By including Existing Contracts, the proposed methodology identifies ex-ante that the application of the wrongly calculated Entry Capacity Reference Price generates an expected **(and not actually obtained)** under-recovery. It cannot be otherwise, as the methodology voluntarily miscalculates the Entry Capacity Reference Price in the first place. The theoretical shortfall in revenues is then recovered via the newly introduced Entry Flow Charge which is set upfront without any realistic visibility over the actually obtained revenue by the TSO. The above explanation clearly demonstrates that the proposal is not compliant with article 4(3)(b) of the TAR NC as it is not making a like-for-like comparison between the allowed transmission services revenue, and the actual revenue collected in the same period. The TAR NC allows for flow-based charges to adjust for any under- or over-recoveries associated with the discrepancies between forecasts and outcomes, as it is recognised that forecasts are rarely 100% accurate.

The above-described non-compliance issue is further exacerbated by the fact that an additional charge already exists in the UK, aimed at addressing any potential under- and over-recovery generated by the system. We refer to the Revenue Recovery Charge (implemented on 01/10/2020), which would continue to exist under the proposal presented in MOD 0790. This means that in the system envisaged by National Grid there would be two separate charges, both aimed at addressing under- and over- recoveries with the only difference that one (the Entry Flow Charge) addresses ex-ante artificially created under-recoveries and the other one (the Revenue Recovery Charge) the ex-post actually created under-recoveries. Besides not being compliant with the TAR NC, such a double charge to address the same issue would generate excessive complexity in the charging system.

Additionally, we highlight that article 17(1)a of the UK TAR NC states that “the under- or over-recovery of the transmission services revenue shall be minimised ...”. This principle means that the amendment would contravene the UK TAR NC as the principle of minimising under- or over-recovery of revenues under Article 17(1)(a) would not be respected.

¹ <https://www.gasgovernance.co.uk/sites/default/files/ggf/book/2019-03/Modification%200678%20v4.0%20%28Change%20Marked%20from%20v3.0%29.pdf> Para 3.39

We attach leading counsel's Opinion confirming our analysis of breach of the TAR NC, and also explaining why this may also be an abuse of National Grid's dominant position in breach of the Competition Act 1998. This Opinion forms part of this response.

2. National Grid failed to demonstrate the proposal is needed in order to address the stated objectives

2.1 The lack of stability and predictability of the Reference Price for Entry Capacity is not caused by Existing Contracts but by the low level of forecast accuracy that National Grid performed in relation to Forecasted Contracted Capacity for Gas Year 2020/21

National Grid (NG) identifies two key aims of the Proposal:

- Reduction of the current differential in the overall level of Transmission Services Entry Charges payable by holders of Existing Contract Capacity compared with holders of other Entry Capacity.
- Reduction in the level of year-on-year volatility in Entry Capacity Reserve Price rates.

NG justifies both of its key objectives for the Proposal in terms of 'providing a more stable and predictable Reference Price for Entry Capacity' and thereby enabling Users 'to set their own service costs more accurately (potentially with a lower risk margin), thereby enhancing effective competition.' However, NG fails to address the main driver of the Reference Price which is National Grid's Forecasting Accuracy. Put simply, the more accurately National Grid forecasts Users future bookings, and hence the revenue that NG will recover, the more stable Reference Prices will be. Forecasting Users' booking behaviour is a function of demand for natural gas in the Great Britain (GB) market, and the sources of supply for this gas. The drivers of supply and demand are well understood. NG's Proposal will not remove the uncertainties associated with supply and demand for gas in GB. Moreover, NG does not address the reasons why its FCC methodology failed to forecast capacity bookings so badly. The only reference to this key issue is as follows:

"Implementation of a new NTS Transportation Charging Methodology from 01 October 2020 was expected to impact capacity booking behaviours on the basis of the removal of zero-priced capacity. This was expected to result in capacity booking levels closer to levels of flow however, ***the unanticipated extent of the reduced capacity bookings at Entry*** in conjunction with the extent of Existing Contracts (with relatively low fixed charge rates) means that a material proportion of Allowed Revenue needs to be recovered from a relatively small proportion of Entry Capacity allocations." (Page 5). (***Emphasis added***)

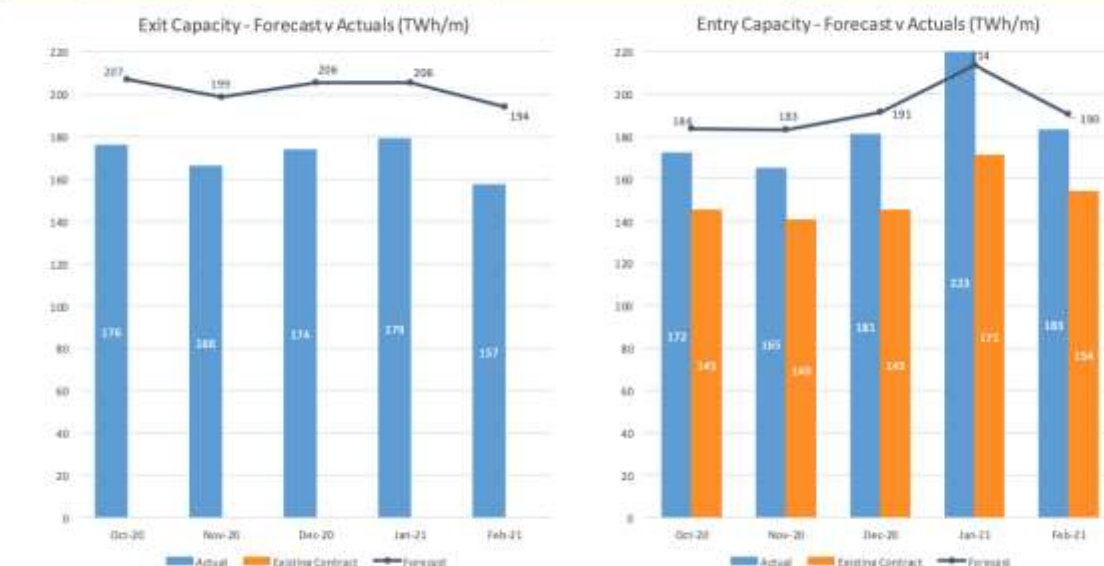
NG explains that it was the 'unanticipated extent' of reduced capacity bookings which caused the problem alongside the Existing Contracts low charge rates. However, the low charge rates of Existing Contracts were well known at the time that the current Charging Methodology was approved. (This issue is examined in more detail below). Therefore, the only material change in circumstances has been the actual level of capacity booking levels compared to the forecast. NG makes no effort to explain or examine why this occurred in the Proposal, and therefore foregoes the opportunity to propose a solution that is more appropriate to solving the underlying problem. It also does not consider if the 'unanticipated' reduction in capacity bookings is a transitory issue, for example due to COVID 19, and therefore not warranting a radical change to the Charging Methodology, or a structural issue requiring reform. If it is the latter, then a much more

detailed analysis of the problem is required. NG has not provided any such analysis in its Proposal.

NG has chosen to propose changes to the Charging Methodology which reverse changes approved and implemented in 2019 and 2020 respectively. Such sudden changes to the Charging Methodology are not conducive to a more stable and predictable Reference Price for Entry Capacity for Network Users. NG is simply failing to solve one problem, the inaccurate forecasting of capacity bookings, and in so doing is creating more uncertainty for Existing Contracts capacity holders. The sudden change in NG's position is even more egregious when considered in the context of the long development of the current regime which extended over the best part of a decade, and involved much discussion between Users, NG and Ofgem.

Separately to the Proposal NG has looked at the FCC methodology. The fact that it is the FCC methodology which is at fault is illustrated by NG's own analysis, shown in the charts below.²

Comparison between Forecast (from FCC 2020/21) to actuals Oct 20 – Feb 21



National Grid

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As can be seen the Forecast overstates the quantity of capacity bookings (black line) compared to the actuals (blue bar). It should be emphasised that the quantity of Existing Contracts capacity, and the revenue associated with it, is known and fixed in advance. Therefore, all that NG has to do to set stable reference prices for capacity is to forecast future capacity bookings reasonably accurately and divide the revenue it requires (excluding the already known revenue from Existing Contracts) by this number. The availability of actual capacity booking data for the first Gas Year 2020/21 of the New Charging Regime will provide a good basis for NGG to improve the level of its Forecasting Accuracy in relation to future FCC.

² Forecasted Contracted Capacity (FCC) Methodology Consultation Webinar on 24th March 2021. Slide 10. <https://www.nationalgrid.com/uk/gas-transmission/document/135091/download>

In addition, the task of forecasting future capacity bookings should be simpler than under the previous Charging Methodology because now most of the entry capacity is priced the same, both by location and duration. There are no longer discounts on firm entry capacity charges with the exception of storage, and the Conditional NTS Capacity Charge Discount ('short haul tariff').

As the GB system has plentiful entry capacity this makes it more likely that Users will book capacity in line with expected flows, and that they will book capacity nearer to the time when they know that they are going to flow gas. Therefore, a reasonable forecast of gas flows should enable a reasonable forecast of capacity bookings. Any variation between forecast capacity bookings and actual will be the result of variations in gas flows. As NG has noted in its Proposal: 'Using flows also provides for greater stability in the denominator as *flow forecasting by National Grid has historically been relatively accurate*, more so than capacity forecasting to actuals.'³ (*Emphasis added*). NG has used this statement to justify a move towards a flow-based charge, but it is not clear why it cannot use the same expertise to forecast capacity bookings more accurately.

In its "UNC678/A/B/C/D/E/F/G/H/I/J: Amendments to Gas Transmission Charging Regime: minded to decision and draft impact assessment"⁴ on 23rd December 2019, Ofgem highlighted the importance of the FCC in setting capacity prices and noted that there was a risk that the FCC would lead to over-forecasting of bookings and hence under-recovery of revenues. It identified that reliance on historic booking levels could make the problem worse in the context of declining gas demand and flows in the future. (Paras 4.46 and 4.47). However, it expected 'relatively small deviations between the FCC and actual bookings.' Nonetheless Ofgem said 'We would also expect amendments to the FCC methodology to be made to ensure that lessons learned from forecasting errors are quickly acted on.' (Para 4.48). NG has not made any attempt to address this issue in the Proposal despite the FCC methodology being the root cause of the changes to the Reference Price. As noted above NG has not allowed any time for the impact of the changes in the FCC methodology to be analysed prior to proposing a further change to the charging regime.

2.2 The exclusion of Existing Contracts from the calculation of the Reference Price was extensively discussed in the process that led to the adoption of the current methodology and it was supported by National Grid and Ofgem

The issues raised by NG, namely the exclusion of Existing Contracts from calculations underlying the Reference Price, and their protection from changes to capacity prices, were explicitly considered in the approval of the current regime. Indeed, it was NG's original proposal to change the charging methodology, UNC Modification Proposal 678, which created the different treatment of Existing Contracts.

Ofgem explicitly addressed the exclusion of the Existing Contracts from the reference price. 'We consider that excluding the capacity and revenue from Existing Contracts from the calculation of the reference price is more appropriate than including them. This is because the revenue to be recovered from Existing Contracts is already known and fixed at the time of the reference price calculation.' (Para 4.49). NG fails to give any reason why the logic of Ofgem's position should be overturned, other than the fact that capacity charges under the new FCC methodology were higher and more volatile than anticipated by NG. As explained above this is the fault of the forecasting, not the exclusion of the

³ <https://www.gasgovernance.co.uk/sites/default/files/ggf/book/2021-11/Modification%200790%20v1.0.pdf> Page 9.

⁴ <https://www.ofgem.gov.uk/publications/amendments-gas-transmission-charging-regime-minded-decision-and-draft-impact-assessment>

Existing Contracts from the calculations. NG already knows how much revenue it will receive from Existing Contracts, so the inclusion of such revenue in the calculation of the reference price does not increase the certainty of that reference price.

Ofgem confirmed the ‘principle based’ analysis (explained above) of the current Charging Methodology in its approval of Modification Proposal UNC 678A on 20th May 2020 (Page 5).⁵ Ofgem also said that it received no specific comments on the exclusion of Existing Contracts from the FCC methodology during the consultation process, indicating that no market participants considered this an issue.

Moreover, it is significant that NG itself, in its Modification Proposal 678 (March 2019) excluded Existing Contracts from the FCC calculation. (The difference between Modification Proposal 678, which was not approved, and the current pricing methodology in Modification 678A is the use of Postage Stamp methodology. Other aspects such as the treatment of the FCC and Existing Contracts was the same.) NG explained that: ‘The alternative approach of inclusion of capacity already booked and revenue levels already ‘set’ via Existing Contracts in the CWD RPM effectively ‘double counts’ any capacity and revenue for the relevant Entry Points and would have the consequence of setting Reference Prices at Entry Points too low to recover the target revenue. Inclusion of these elements in the CWD RPM would therefore be inconsistent, and arguably non-compliant, with Article 17 (of the EU TAR Network Code).’ (Para 3.39 *Emphasis added.*)⁶ NG does not adequately explain its reversal of position, and hence fails to justify the need to change the current methodology under Modification Proposal 790.

2.3 The existence of differentials in revenue recovery levels and capacity charges between Existing Contracts and other capacity users was already well known and analysed by National Grid, Baringa and Ofgem when the current regime was approved and implemented. The differentials have not changed materially in the meantime.

NG argues that the current methodology leads to unit charges for new Entry Capacity being ‘on average 23 times’ the unit price paid for capacity under Existing Contracts. However, this calculation is wrong on two counts. Firstly, it takes no account of the utilisation of the capacity under Existing Contracts. According to the Frontier Economics note ‘Gas Transmission charging reform: Response to comments on Frontier’s assessment of National Grid UNC modification proposal. 25th November 2021’ the actual utilisation for Existing Contracts capacity was 52% in 2020/21 (Page 2). This would mean that the effective unit cost for Existing Contracts Capacity is double the figure which NG uses as the basis for its justification for the Proposal. Even if NG’s arguments in favour of reducing the differential are justified under the UNC Relevant Objectives (which they are not – see below), the differential is much smaller than NG claims. Whilst new capacity users are able to profile their capacity bookings in line with their expected usage by booking close to the time of gas flow, this opportunity is not available to Existing Contracts capacity holders who have taken a long-term position well in advance of the gas flows. The true cost to Existing Contract holders is not therefore the unit price, but the total cost of the Existing Contracts capacity divided by the actual flows i.e. the utilisation.

This also underpins the second reason why NG’s comparison of unit prices is flawed. It takes no account of the risk that Existing Contracts capacity holders have taken on by

⁵ https://www.ofgem.gov.uk/sites/default/files/docs/2020/05/unc678_-_decision_0.pdf

⁶ <https://www.gasgovernance.co.uk/sites/default/files/ggf/book/2019-03/Modification%200678%20v4.0%20%28Change%20Marked%20from%20v3.0%29.pdf>

making a long-term booking. Existing Contracts holders have a long-term liability which they must account for on their balance sheet as they are committed to pay for the capacity irrespective of their actual usage. The Frontier Economics analysis makes great play of the risk management costs that new capacity users and NG incur because of the volatility of the capacity prices. As shown above this volatility is the fault of NG's Forecasted Contracted Capacity (FCC) methodology. But the Frontier Economics' analysis makes no reference to the costs of managing risk that Existing Contracts capacity holders face, namely the long-term liability of the Existing Contracts. The Frontier Economics analysis is therefore one-sided, and any comparison of Existing Contracts and new capacity users should also take into account risk management costs faced by Existing Contract holders as a result of taking long term positions on capacity bookings.

NG argues that 'implementation would enable a more equitable recovery of Allowed Revenue at Entry.' It attempts to justify its proposed changes on the grounds that there is significant disparity between the capacity charges that Existing Contracts pay, and the charges that other users pay under the current pricing methodology. However, the existence of any differences in capacity prices paid is not enough, on its own, to merit a change to the current methodology. As noted above the issue of Existing Contracts was clearly identified in both NG's and Ofgem's analysis of the current charging methodology. Therefore, it is necessary to see if there has been a significant change in the price differentials compared to the analysis undertaken in 2019, or if there has been a fundamental change to competition between network Users in the GB gas market that undermines the rationale for approval of the current charging methodology. NG has failed to demonstrate that either is the case and therefore fails to justify the need for the changes in Modification Proposal 790.

In its "UNC678/A/B/C/D/E/F/G/H/I/J: Amendments to Gas Transmission Charging Regime: minded to decision and draft impact assessment" on 23rd December 2019, Ofgem noted that Existing Contracts would face lower charges. Both NG Modification Proposal 678 and the approved Modification 678A treated Existing Contracts in the same way. Ofgem further noted:

'While we consider that protection of Existing Contracts may therefore lead to a 'dual regime', we also consider that this presents a transitional arrangement which provides appropriate price protection for a limited period of time. We note that the volume of Existing Contracts will reduce over time as Existing Contracts come to the end of their contractual period (see Figure 0.2). Therefore, the issues presented will be transitional.' Para. 4.71.

This has not changed, so it is not clear why a transitional issue, and one which NG supported in its own Modification Proposal 678, has now become one which warrants urgent change. As only contracts signed before 2017 can claim to be Existing Contracts, the issue will remain a transitional one.

In 2019 NG commissioned Baringa to look at the impact of price differentials between new and existing contracts.⁷ Baringa found that for 2021-22 Existing Contracts would account for 60% of Forecast Contracted Capacity using NG's methodology but only 12% of revenues.⁸ This would mean that new users would have to make up for the remaining revenues, which in turn implies tariff differentials. In other words, the existence of

⁷ [https://www.gasgovernance.co.uk/sites/default/files/ggf/book/2019-](https://www.gasgovernance.co.uk/sites/default/files/ggf/book/2019-04/Tariff%20differentials%20between%20new%20and%20existing%20contracts%20-%20Baringa%20report...pdf)

[04/Tariff%20differentials%20between%20new%20and%20existing%20contracts%20-%20Baringa%20report...pdf](https://www.gasgovernance.co.uk/sites/default/files/ggf/book/2019-04/Tariff%20differentials%20between%20new%20and%20existing%20contracts%20-%20Baringa%20report...pdf)

⁸ Ibid. Page 8.

significant tariff differentials was already known, and taken into account when the current Charging Methodology was approved and implemented based on the sound compliance with EU TAR NC and common sense that was captured by Baringa's report commissioned by NGG: "To limit regulatory risk and to provide investors with a degree of certainty that enables them to undertake significant investments, regulators generally seek to avoid retroactive changes to contracts already agreed." There has not been a significant change to the relative shares of Existing Contracts and new users. NG now states that 'the Existing Contract capacity for Gas Year 2021/22 equates to 71% of total forecast Entry Capacity quantity (kWh) to be booked however it is forecast to only collect 10% of the total Allowed Revenue (£) at Entry.'⁹ This change is driven by the 'unanticipated' reduction in actual capacity bookings compared to the FCC, not because of any change to the quantity or pricing of Existing Contracts, or their protection under the Charging Methodology. The change in outcome is also small - Existing Contracts share of revenues only declines slightly. It is therefore not clear why there needs to be a change to the current methodology as the order of magnitude of revenue recovery differentials between Existing Contracts and other users is broadly the same.

2.4 The price differential for capacity between Existing Contracts and other users does not undermine competition, as demonstrated by Baringa in 2019 and by Frontier Economics in the Impact Assessment on Modification Proposal 790

The issue of a 'dual regime' whereby Existing Users pay lower prices than other users was extensively considered by NG, Ofgem and the European Agency for Cooperation of Energy Regulators (ACER) prior to the adoption of the current pricing methodology. In particular, the analysis focused on the impact of such a 'dual regime' on competition between network users. The findings were that such a differential did not cause competition problems, and hence the current treatment of Existing Contracts was proposed and supported by NG and approved by both Ofgem and ACER. As nothing has changed, that was not considered at the time with the exception of NG's FCC methodology failure to take account of the 'unanticipated' reduction in capacity bookings by other users, NG's proposal to change the methodology cannot be justified.

Nonetheless NG attempts to argue that large price differentials for capacity between Existing Contracts and other users now does undermine competition. It is therefore worth examining the original analysis supporting such differentials, and whether this analysis is still valid.

Significant differentials in prices paid for entry capacity have existed for many years and are not a new feature of the Charging Methodology. Under the previous methodology entry capacity prices were based on a capacity charge and commodity charge. Under a policy encouraged and sustained by Ofgem over many years, there were significant discounts on the entry capacity charge, including 33% for capacity booked day-ahead and 100% for capacity booked on the day. All users had to pay the same commodity charge based on gas flowed. However, the capacity booking rules and plentiful capacity compared to gas flows meant that it was possible for many network users to profile their capacity bookings for when they needed it, and also enjoy discounted capacity costs. By contrast Existing Contracts capacity holders paid the full price for entry capacity and the commodity charge. Any 'advantage' enjoyed by Existing Contracts capacity holders must be weighed against the 'disadvantage' they faced over many years under the previous regime. This reflects a wider truth about competitive markets, namely that costs facing market participants reflect decisions taken at a certain point in time, and the competitive

⁹ <https://www.gasgovernance.co.uk/sites/default/files/ggf/book/2021-11/Modification%200790%20v1.0.pdf> Page 7.

strategy of the individual participants. It is notable that gas market participants face similar differences in costs when buying or selling gas. For example, market participants who bought gas forward in 2020 when prices were very low will currently enjoy an advantage compared to those who rely on the spot market.

The key question is whether the different capacity costs facing network users results in an advantage which is detrimental to competition. The views of NG, Ofgem and ACER were unanimous in 2019 and 2020 that it did not.

Baringa, in the analysis commissioned by National Grid in 2019, concluded that any impact of tariff differentials would be limited because of the following:

- Overbooking of capacity relative to expected demand meant that there would be a secondary market in capacity which would give Existing Contracts capacity holders an incentive to sell excess capacity to new entrants, potentially at a discount to the Existing Contracts capacity tariff.
- “[...] normal variation in the price of gas can create significant differences in wholesale cost of gas between different shippers. Also, tariff variation for new contracts is of a similar order of magnitude as the tariff variation across new and existing contracts. Both effects introduce random variation in the merit order that is likely to dominate any cost differential between new and existing contracts and limit the magnitude of the effects of the price differential between new and existing contracts on gas market dynamics.” (Page 28)
- ‘The tariff differential will fall away over time as the share of existing bookings in total flows falls and the extent of tariff under-recovery decreases. This will mean that the extent of any adverse effects on competition, consumer welfare, and broader gas market dynamics, is also set to fall over time.’ (Page 28)

All these factors continue to hold true, so it is not clear why NG no longer feels comfortable with its current methodology. Moreover, the large increase in wholesale natural gas prices mean that the impact of any capacity charge differential is likely to be even less relevant to gas market dynamics than it was at the time of the Baringa analysis.

NG has since commissioned Frontier Economics to provide an Impact Assessment on Modification Proposal 790.¹⁰ The Frontier Economics analysis supports the earlier Baringa analysis, and thereby undermines the NG case for the changes to the Charging Methodology. Specifically, it says that:

‘There could be a concern that the existence of cheap long-term booked capacity results in a distortion to gas supplies but *there are economic reasons why the presence of ECs should not result in distortions to competition* (between sources at a given Entry Point).’ (Page 10. *Emphasis added.*)

Frontier goes on to explain that there is an opportunity cost of holding Existing Contract if someone is willing to pay the Entry Capacity Price (i.e. the price paid by other capacity users). This makes the cost of using Existing Capacity the same as new capacity; whilst this may result in a windfall for Existing Capacity holders it will not drive a change in behaviour in terms of which party flows gas and supplies the GB market, and hence will not impact competition.

¹⁰ <https://www.gasgovernance.co.uk/sites/default/files/ggf/book/2021-11/NGG%20charging%20reform%20-%20impact%20assessment%20-%20final%20-%2020291121%20stc.pdf>

Although Frontier identifies two possible situations where Existing Contracts could distort competition, Frontier is not convinced of the materiality of their impact on competition. Frontier says, ‘*To the extent that such distortions exist, they will be reduced in the factual by introducing a flow-based charge.*’ (Page 13 *Emphasis added.*) Frontier further notes that ‘While distortions (to competition) are possible in practice, in our view they are unlikely to be material.’ (Page 14). This is because the costs of entry capacity charges, and the changes between the current and proposed capacity charges, are so small compared to the NBP gas price. In effect the Impact Assessment of Modification Proposal 790 commissioned by NG undermines the case for Modification Proposal 790.

The Frontier Economics analysis attempts to justify Modification Proposal 790 by arguing that ‘Charges are difficult to set accurately, principally due to the presence of Existing Contracts, and therefore there is the potential for significant under- or over-recovery which must be addressed as part of charges for future years’ and that this creates risks for market participants. This is wrong. The level of Existing Contracts revenue and capacity bookings is known and fixed for any given gas year. The level of Existing Contracts revenue only changes as contracts expire, and NG knows the expiry dates in advance. In fact, charges are difficult to set accurately because of the uncertainty surrounding users’ capacity booking behaviour, and NG’s inadequate FCC methodology, as explained above.

ACER, in its report Analysis of the Consultation Document on the Gas Transmission Tariff Structure for Great Britain (2020),¹¹ concluded that the proposed methodology ‘should not lead to undue discrimination between network users in Great Britain.’ (Page 13). NG points out that ACER also recommended ‘Ofgem to closely monitor the impact of this ‘dual regime’ in the coming years and to implement remedies if detrimental effects were such that they would significantly affect competition in a negative way.’ However, NG has failed to demonstrate that it is the dual regime which is the cause of the problem which NG seeks to fix, as opposed to the FCC methodology. In its final decision approving Modification 678A¹² Ofgem concluded that the current methodology would better facilitate ‘securing effective competition’ than the previous methodology despite the existence of the dual regime and the expected differentials in tariffs.

2.5 NG has allowed insufficient time for robust analysis, and its constant changes are undermining market confidence.

The urgent status granted to this Mod did not give enough time for a robust analysis, although the extent of the proposed changes requires a thorough impact assessment. Thus NG’s constant changes to the Charging Methodology and key components such as the FCC are themselves undermining market confidence and the ability of shippers to set their own service costs accurately. The current methodology was only introduced in October 2020. The FCC methodology was itself updated for the Gas Year 2021/2022. The new FCC methodology, which makes use of historical flows as a basis for the FCC methodology, results in a reduced forecast of Forecast Contracted Capacity,¹³ and therefore might be expected to result in a lower level of under-recovery and hence more stable capacity charges than has been experienced to date. NG has not allowed time for the impact of the changes in the FCC methodology to be considered before proposing

¹¹ https://documents.acer.europa.eu/Official_documents/Acts_of_the_Agency/Publication/Agency%20report%20-%20analysis%20of%20the%20consultation%20document%20for%20Great%20Britain.pdf

¹² https://www.ofgem.gov.uk/sites/default/files/docs/2020/05/unc678_-_decision_0.pdf

¹³ Based on initial analysis shown in the Forecasted Contracted Capacity (FCC) Methodology Consultation Webinar on 24th March 2021. Slide 16. <https://www.nationalgrid.com/uk/gas-transmission/document/135091/download>

another change to the Charging Methodology. In addition, the impact of changes to short haul is expected to be important, but as there is only two months of data available so far, it is not yet possible to analyse the full impact of these changes.

2.6. The Frontier Economics distributional analysis is flawed and not a relevant criterion for approving implementation of the Proposal.

The Frontier Economics Impact Analysis involves a number of “key simplifications / conceptual assumptions.” (Slide 29), such as “full pass-through of capacity charges” (slide 33) and “if EC holders are marginal, they may still be able to price capacity at the full value of the capacity charge” (slide 34). Without a full and detailed economic study with robust assumptions and detailed modelling looking at the impact on supply and demand for the UK gas market in relation to marginal sources of gas supply and demand and the interaction with other competing markets throughout the year, we find the simplified aggregate approach taken by Frontier Economics to be flawed and the resulting (very limited) consumer benefits cannot be supported. The Frontier Economics analysis has not taken into account the potential impact on marginal imports to the UK in the form of LNG and pipeline gas from Norway. For example, Norwegian pipeline gas has the choice of flowing into the UK via pipelines such as Langeled, or of flowing to continental Europe via pipelines to Belgium, France and Germany. Norwegian gas therefore has the opportunity of arbitrage between these markets, and any tariff increase in flowing gas into the GB market will make alternative markets more attractive. The same logic applies to LNG cargoes which can land in the UK, or at terminals in northern France, Belgium, and the Netherlands. Moreover, if the impact of the new charges is to make it more attractive to export gas that enters at Bacton UKCS to either Belgium or The Netherlands via the interconnector or BBL using short haul tariffs, then less gas may flow to into the GB market with a consequent increase in wholesale gas prices that has not been considered in any analysis.

It should also be noted that the questionable distributional effects highlighted by Frontier Economics are not a valid criterion for approving the Proposal. The key criteria are:

- Transporters’ Relevant Objective (d) – “Securing of effective competition (i) between relevant shippers; (ii) between relevant suppliers”
- Transporters’ Relevant Charging Methodology Objectives (C) - “Compliance with the charging methodology facilitates effective competition between gas shippers and between gas suppliers.”

Neither the Frontier Economics analysis, nor the Proposal itself have demonstrated that the Proposal meets the above two objectives, either directly or as a result of the distributional effects. Therefore, the distributional effects are not a valid ground for approving the Proposal.

Conclusion

On the basis of the concerns expressed in this document we strongly oppose MOD 0790. The proposal cannot be implemented without a broader discussion aimed at clearly identifying the objectives of the reform and finding the proper solutions. Such a broader assessment should carefully analyse the compliance with the TAR NC and any potential changes to such Code that would need to be made before this proposal can be implemented.