NTSCMF/ SUB GROUP – EXISTING LONG TERM CAPACITY CONTRACTS (EC)

The key term in relation to Existing Capacity:

Term	Detail
Existing Capacity	The long-term entry capacity bookings that apply for the charging period post-October 2019 and that were concluded before 6 April 2017. *Commission Regulation (EU) 2017/460 establishing a network code on harmonised transmission tariff structures for gas (TAR NC)* *Article 35* **Existing contracts** 1.This Regulation shall not affect the levels of transmission tariffs resulting from contracts or capacity bookings concluded before 6 April 2017 where such contracts or capacity bookings foresee no change in the levels of the capacity- and/or commodity-based transmission tariffs except for indexation, if any. 2.The contract provisions related to transmission tariffs and capacity bookings referred to in paragraph 1 shall not be renewed, prolonged or rolled over after their expiration date. 3.Before 6 May 2017, a transmission system operator shall send the contracts or the information on capacity bookings, if any, referred to in paragraph 1 to the national regulatory authority for information. *17.3.2017 L 72/54 Official Journal of the European Union EN*

Background

The current charging regime provides gas shippers with an option to secure long-term entry capacity at a fixed price agreed at the point when capacity is allocated via the auction process for up to 17 years ahead. If gas shippers opt not to use their existing capacity, they pay no further capacity nor commodity charges.

The current regime offers up to 100% price discounts for short-term entry capacity (equal to Multipliers of 0 under the new regime). When long-term users buy capacity for a time frame longer than one day, they in essence buy daily capacity rights "in bulk" or a series of daily capacity products for any given day within that specific time frame. Although long-term capacity holders buy exactly the same daily capacity product as short-term capacity holders, they pay a much higher capacity cost than short-term holders who predominantly purchase their capacity free of charge. This results in effective discrimination between long-term and short-term capacity holders because short-term holders are not making any adequate contribution to the historical costs incurred by National Grid Gas (NGG) to deliver the entry capacity. Therefore, short-term holders are enjoying network provision and developments supported by long term capacity holders who made long-term capacity commitments.

The concept of the fixed-price capacity contract is important in the current charging regime because it helps ensure a level playing field among all shippers and limits negative effects of a cross-subsidy. Some gas shippers have no choice but to secure long-term entry capacity in order to:

- prevent capacity from being substituted away to another ASAP;
- secure access to the market for their new projects;
- meet a pre-condition for the new investment;
- provide National Grid with an incremental capacity signal;

- secure and fix the price of an option to deliver gas to the UK.

Gas shippers with more flexible business needs can opt to buy long-term entry capacity for other reasons, such as:

- a low-risk appetite;
- a preference to opt for a less labour-intensive capacity-management process associated with long-term capacity bookings (it is easier to place one capacity transaction then numerous daily transactions);
- managing the scope for administrative errors when booking entry capacity – Uniform Network Code (UNC) does not make any provisions for administrative errors; gas shippers who make such errors can face high penalties or unexpectedly high capacity invoices.

Short-term discounts in capacity price provide all gas shippers with a large incentive to secure their capacity on a short-term basis, mostly at zero price. Because large quantities of short-term capacity are sold at zero price, this results in a large TO capacity revenue shortfall and a cross-subsidy by long-term capacity holders to short-term capacity holders. The TO revenue shortfall is resolved by the application of the uniform TO commodity charge that is solely a gas flow-related charge (i.e. it does not apply to any capacity bookings).

In this context, it is worth mentioning that fixed-price existing capacity contracts offer shared benefits to all UNC users such as :

- NG benefits from the knowledge that they will be able to collect the capacity revenue on a long-term basis via the known fixed price; the long-term bookings provide some locational signals to NG;
- Gas shippers who buy capacity on a short-term basis benefit from the lower commodity charge that is reflecting lower capacity revenue under-recovery (because capacity revenue is collected from long-term contracts);
- The existing capacity holders pay a higher price for long-term capacity but they benefit from the knowledge that this price will not change until the contract expires and that they have secured an option to flow gas.

The removal of the fixed-price contract from the future regime and the effect on existing long-term capacity holdings

When the new charging regime is implemented in October 2019, it is planned that the fixed-price long-term entry capacity contract will be removed from the UNC by introduction of the new top-up floating capacity charge. The purpose of the top-up floating charge will be to ensure full NGG revenue recovery. Therefore the higher the revenue under-recovery, the higher the top-up floating charge and the more significant negative impact on existing capacity holders.

Unless long-term existing capacity holders are provided with the possibility to return the capacity that was purchased under different contractual terms, they will not be provided with the ability to adjust their capacity booking behavior in response to significant changes in the regulatory framework brought about by the new regime. In this latter scenario, a significant competitive advantage will be conferred to gas shippers without existing capacity (or lower levels of existing capacity bookings) because they will have an opportunity to adjust their capacity booking strategy to the new charging regime.

Furthermore, gas shippers who will be most negatively affected by the removal of the fixed-price capacity contract and the introduction of the top-up capacity tariff will be those who are unable to utilise their long-term existing capacity.

The negative impact that can be caused by the introduction of the new charging regime can be mitigated or exacerbated depending on the decision-making process in relation to the charging modifications to the UNC. In the worst case scenario, the modifications to the UNC and possibly to the NGG licence could mean that:

- Existing long-term capacity holders, who are unable to utilise their capacity, are in a worse position because they will be forced to pay a high variable top-up charge that they did not expect to pay when they decided to make a commitment to the long-term capacity bookings;
- Existing long-term capacity holders, particularly if they are unable to utilise their capacity, will have to pay much higher total capacity charges that will put them at a significant competitive disadvantage by increasing a cross-subsidy by existing capacity holders to other users.

A situation must be prevented whereby gas shippers who bought long-term capacity at one price are to suffer from a significant increase in the price that they have to pay for such capacity as a result of the regulatory intervention.

For all these reasons, and without satisfactory modifications to the UNC, the treatment of the existing capacity holdings in the new regime risks amounting to a serious distortion of competition, and at the same time causing the market to become inefficient and uncertain.

Both long-term and short-term capacity holders buy exactly the same – a daily capacity product. However, long-term capacity holders will pay a disproportionately higher price for their capacity than those capacity holders who book capacity in the short-term. This causes a market inefficiency because it exaggerates the difference between different classes of capacity holders and is likely to lead to a reduction in investment and long-term capacity bookings, as a result of which prices are likely to be distorted.

Ultimately, inadequate mitigation through the UNC modifications risks shippers being less willing to book long-term capacity in the future, with adverse effects to security of supply. The latter point is also related to section 4AA of the Gas Act which protects interest of consumers as they relate to the security of supply.

Relevant Objectives

The Relevant Objectives include:

a) Save in so far as paragraphs (aa) or (d) apply, that compliance with the charging methodology results in charges which reflect the costs incurred by the licensee in its transportation business;

aa) That, in so far as prices in respect of transportation arrangements are

established by auction, either:

(i) no reserve price is applied, or

(ii) that reserve price is set at a level -

(I) best calculated to promote efficiency and avoid undue preference in the supply of transportation services; and

II) best calculated to promote competition between gas suppliers and between gas shippers;

b) That, so far as is consistent with sub-paragraph (a), the charging methodology properly takes account of developments in the transportation business;

c) That, so far as is consistent with sub-paragraphs (a) and (b), compliance with the charging methodology facilitates effective competition between gas shippers and between gas suppliers; and

d) That the charging methodology reflects any alternative arrangements put in place in accordance with a determination made by the Secretary of State under paragraph 2A(a) of Standard Special Condition A27 (Disposal of Assets).

e) Compliance with the Regulation and any relevant legally binding decisions of the European Commission and/or the Agency for the Co-operation of Energy Regulators

Given the emphasis of the Relevant Objectives on efficiency and effective competition, it is clear that an approach that distorts the price of entry capacity, and fails to take any mitigating steps to prevent the resultant damage to gas shippers that bought that capacity on the legitimated basis that existing capacity would maintain its fixed price, risks being not compliant with a number of Relevant Objectives and, in particular, those described above.

Options to provide the right solution:

In order to mitigate the adverse effects that will result from the removal of the fixed-price capacity contract and the introduction of a top-up floating capacity charge in the new charging regime and to comply with the legal obligations set out above, before the new charging regime is implemented the modification to the UNC must:

- make provision for existing long-term capacity holders to offer an option to return their capacity; and
- to the extent that such capacity is retained, make provision for continued use on the same price terms.

Discusion: to be developed