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Modification proposal:	**Uniform Network Code (UNC) 0748: Prospective Removal of Entry Capacity Revenue from Capacity Neutrality Arrangements (UNC748)**		
Decision:	The Authority[1] directs this modification be made[2]		
Target audience:	UNC Panel, Parties to the UNC and other interested parties		
Date of publication:	23 December 2020	Implementation date:	1 January 2021

Background

On 5 November 2020, National Grid Gas Transmission (**"NGGT"**, the proposer) informed the UNC Transmission Workgroup of a significant under-recovery of its allowed revenue based on October 2020 data.[3] NGGT attributed this mainly to lower-than-forecast capacity bookings and the operation of capacity neutrality arrangements.

The Capacity Neutrality arrangements redistribute specific costs and revenues across entry users. Historically, a number of financial transactions were included in this category. The rationale for the Capacity Neutrality arrangements was to ensure that the System Operator would be held cash neutral in relation to the financial transactions that fell within this category. As a result, the cashflows that are subject to capacity neutrality are not treated as collected revenue.

The cashflows that are attributed to capacity neutrality, and thus redistributed to users, have increased significantly since 1 October 2020, when the new charging transmission arrangements were implemented.[4] Since these cashflows into capacity neutrality are not treated as collected revenue, this has contributed to a significant under-recovery of revenue.

NGGT has stated that it would address the under-recovery via the use of Transmission Services Revenue Recovery Charge (**"TSRRC"**)[5] and a UNC modification proposal with respect to capacity neutrality that would "avoid disadvantaging any Shipper and preserve the integrity of the charging methodology".[6]

UNC748 seeks to remove the charges paid by Users for daily interruptible and within day entry capacity from capacity neutrality on a prospective basis. UNC748 would mitigate some of the prospective under-recovery that NGGT has reflected in the recently published entry TSRRC. Additionally, UNC748 includes a proposal that would enable NGGT to issue a pricing notification at short notice which it has suggested could be used to reduce TSRRCs.

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[1] References to the "Authority", "Ofgem", "we" and "our" are used interchangeably in this document. The Authority refers to GEMA, the Gas and Electricity Markets Authority. The Office of Gas and Electricity Markets (Ofgem) supports GEMA in its day to day work. This decision is made by or on behalf of GEMA.
[2] This document is notice of the reasons for this decision as required by section 38A of the Gas Act 1986.
[3] See minutes of meeting at: https://www.gasgovernance.co.uk/tx/051120
[4] On 28 May 2020, we approved modification proposal UNC678A which introduced far-reaching reforms to the GB gas transmission charging regime. The new arrangements were implemented on 1 October 2020.
[5] The value of the announced entry revenue recovery charge was set at 0.0717 p/kWh/day and the exit revenue recovery charge was set at 0.0124 p/kWh/day. This was done with a pricing notification issued on 30 November 2020 https://www.nationalgrid.com/uk/gas-transmission/document/133866/download
[6] NGGT position is captured in Transmission Workgroup Minutes for 5 November which are available at https://www.gasgovernance.co.uk/tx/051120

UNC748 was raised by NGGT on 8 December 2020, requesting urgent status and to follow an expedited timetable, which we decided to grant on the same day.[7]

The modification proposal

UNC748 proposes two changes:

- to remove charges paid by users for daily interruptible and within day entry capacity from capacity neutrality with effect from the date of implementation;[8] and
- a one-off opportunity for price change notifications to be made with a shorter notice period than those currently set out in the UNC. This is proposed to be a limited opportunity to revise TSRRCs, which can only be exercised once and only shortly (within 2 months) after UNC748 is approved. UNC748 will not change the normal notice period for price notifications set out in the UNC on an enduring basis.

Implementation will have the effect that daily interruptible and within day entry capacity charges will contribute to NGGT's allowed revenue stream. This will remedy an anomaly, whereby significant cashflows generated by these products currently do not contribute to allowed revenue but are being re-distributed to shippers causing competition distortions. Furthermore, this modification will reduce some of the effect of the anomaly that NGGT has addressed when setting the entry TSRRC. Finally, NGGT will have an opportunity to make a change to revenue recovery charges at shorter than normal notice periods.[9]

Prior to 1 October 2020, daily interruptible and within day entry capacity was sold in price auctions which had a zero reserve price. Historically, these capacity products contributed very low cashflows into the capacity neutrality mechanism. Since 1 October 2020, these capacities have been sold in auctions with a positive reserve price.[10]

These cashflows are currently redistributed via the capacity neutrality mechanism in proportion to a user's firm entry capacity holdings. Therefore, users holding interruptible and within day firm entry capacity pay the value of this capacity and those holding firm entry capacity (with includes those procuring firm capacity ahead of the day[11] and within day) receive those monies. NGGT has stated in its consultation response that capacity neutrality revenues have increased from typically around £100k per month to around £15m per month.[12]

Due to the under-recovery that otherwise would have occurred since 1 October 2020,[13] NGGT has announced TSRRCs to apply from 1 February 2021, seeking to make up the

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[7] https://www.ofgem.gov.uk/publications-and-updates/uniform-network-code-748-urgent-prospective-removal-entry-capacity-revenue-capacity-neutrality-arrangements-urgency-application

[8] NGGT has indicated an intention to raise another proposal to address the retrospective treatment of such revenues in relation to the period on and after 1 October 2020 until the UNC748 implementation date.

[9] UNC748 would allow a one-off update of TSRRCs, 'with a notice period of less than 2 months and no less than 5 business days'. The legal text states that this shorter notice period can only be invoked once.

[10] The auction reserve price is 0.0717 p/kWh for within day firm entry capacity and 0.0645 p/kWh for interruptible capacity

[11] This includes entry capacity procured prior to 6 April 2017 ('Existing Contracts'), and that booked later up to the day before the capacity right.

[12] See https://www.gasgovernance.co.uk/0748/Reps

[13] NGGT provided data on the observed under-recovery during a webinar held on 8 December 2020: https://www.nationalgrid.com/uk/gas-transmission/document/134021/download

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shortfall.[14] A significant part of the TSRRC at entry is attributable to the capacity neutrality arrangements. The entry revenue recovery charge is levied on firm entry capacity holdings (other than that purchased prior to 6 April 2017[15]). NGGT has set the entry TSRRC at 0.0717 p/kWh/day effectively doubling the price of entry capacity.

UNC748 will reduce the prospective cashflows into capacity neutrality and hence allow user payments for interruptible and firm within day entry capacity to be treated as collected revenue. NGGT says the opportunity associated with the reduced notice period for price changes, and a timely decision to implement UNC748, would allow it to reduce the already announced entry TSRRC.

UNC Panel[16] recommendation

At the UNC Panel meeting on 17 December 2020, a majority of the UNC Panel considered that UNC748 would not better facilitate the UNC objectives and the Panel therefore did not recommend its approval.[17]

Our decision

We have considered the issues raised by the modification proposal and the Final Modification Report (**"FMR"**) dated 17 December 2020[18]. We have considered and taken into account the responses to the industry consultation on the modification proposal which are attached to the FMR. We have concluded that:

- implementation of the modification proposal will better facilitate the achievement of the relevant objectives of the UNC;[19] and
- directing that the modification be made is consistent with our principal objective and statutory duties.[20]

Reasons for our decision

Assessment of consultation responses

Twenty one responses to the consultation were submitted to the Joint Office of Gas Transporters. Eight were in support, two were opposed, seven offered qualified support and four offered comments.

The consultation generated wide ranging feedback on various issues, such as:

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[14] NGGT's pricing notification states that the RRCs will apply for the period February-June 2021 (entry RRC) and February-March 2021 (exit RRC) : https://www.nationalgrid.com/uk/gas-transmission/document/133866/download

[15] These capacity holdings ('Existing Contracts') are grandfathered under Article 35 of Commission Regulation (EU) 2017/460 of 16 March 2017 establishing a network code on harmonised transmission tariff structures for gas.

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

[17] Panel Members voted with 4 votes in favour (out of a possible 14), and therefore did not agree to recommend implementation of UNC748.

[18] https://www.gasgovernance.co.uk/sites/default/files/ggf/book/2020-12/Final%20Modification%20Report%200748%20%28Urgent%29%20v2.0.pdf

[19] As set out in Standard Special Condition A11(1) of the Gas Transporters Licence, available at: https://epr.ofgem.gov.uk//Content/Documents/Standard%20Special%20Condition%20-%20PART%20A%20Consolidated%20-%20Current%20Version.pdf

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

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- the divergence between forecasted contracted capacity (which is used in setting reserve prices) and capacity bookings observed since October;
- the period chosen by NGGT to apply the announced TSRRCs (ie five months on entry and two months on exit);
- the market impact caused by the significant TSRRCs announced for 1st February 2021;
- the impact of cashflows on NGGT's constraint management incentive which may lead to significant revenues for NGGT.

Many of the wider issues mentioned above, though important, are beyond the scope of UNC748. UNC748 proposes to remove daily interruptible and within day entry capacity from capacity neutrality with effect from the date of implementation. It also proposes a one-off opportunity for NGGT to revise the already announced TSRRCs with shorter notice. In this letter, we assess whether these proposed changes better facilitate the applicable UNC objectives and whether the approval of this proposal would be consistent with our statutory duties. We note industry's concerns regarding the forecasting inaccuracies and the TSRRCs announced by NGGT on 30 November 2020. However, we note that these issues predate UNC748 and are not part of this modification. We have urged NGGT to ensure that these issues are addressed in a timely manner and we are planning on publishing our views in due course. Finally, we note that exploring the impacts on NGGT's constraint management incentive is an important issue that warrants further consideration but it nevertheless is not directly relevant to UNC748 and will therefore not be addressed in this letter.

In our UNC748 urgency decision, we asked the Joint Office to include three questions within the consultation response template and stated that we expect parties to give these due consideration.[21]

Capacity neutrality

We asked respondents to the consultation if they agree with the proposal that the treatment of interruptible and within day firm entry capacities feeding into capacity neutrality is inappropriate. We also asked respondents if they agree with the proposal that these revenues should be removed from capacity neutrality.

The majority of respondents considered the current treatment of interruptible and within day firm capacities within the capacity neutrality mechanism is not appropriate and supported their removal from capacity neutrality arrangements. Some responses invited a wider review on the capacity neutrality mechanism.

Some respondents stated that the contribution of substantial sums to capacity neutrality give rise to a distortion, which is exacerbated by the application of TSRRCs that NGGT has announced. Furthermore, some stakeholders stated that the current situation is increasing costs of delivery of gas into the GB market and costs of use of storage.

Notice period

We asked respondents if they support the proposal that NGGT should be granted a one-off relaxation of its obligation to provide two months' notice of pricing changes?

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[21] See Annex to our decision letter: https://www.ofgem.gov.uk/publications-and-updates/uniform-network-code-748-urgent-prospective-removal-entry-capacity-revenue-capacity-neutrality-arrangements-urgency-application

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Some respondents supported the one-off relaxation of NGGT's obligation to provide two months' notice of pricing changes. However, others expressed concerns that this could be disruptive to the market and could set an undesirable precedent. A number of consultation responses indicated that UNC748 would allow an inappropriate reduction in notice requirements. UNC748 states that: "Update of the updated Transportation Charge rates will take effect at the earliest opportunity with a notice period of less than 2 months and no less than 5 business days". The 5 business days referenced in the modification proposal is the minimum notice allowed under UNC748.

NGGT must carefully consider the trade-off between the risks of disruption created by very short notice period charge changes and the increased accuracy of prices that might arise from a longer period of experience feeding the price determination. However, we would expect NGGT to provide as much notice to industry participants as possible before any changes are applied, and aim to provide a minimum of 30 days' notice.

Assessment against objectives

Although the modification proposal would not introduce any changes to the charging methodology, it would have an impact on the applicable charges for NTS users as it would remove significant cash flows from the capacity neutrality arrangements and would allow NGGT to reduce the already announced entry TSRRC. We have, therefore, assessed the modification proposal against the UNC Relevant Code Objectives and UNC Charging Methodology Relevant Objectives (**"CMROs"**). As there are similarities between the two sets of objectives, we assess them in tandem.

We consider that the modification proposal better facilitates UNC objectives (c), (d), (e), (f), (g), and UNC CMRO (c), and (e). We consider that UNC objectives (a), (b), and UNC CMRO (a), (b), (d) are not relevant to this modification proposal.

UNC objective (c) so far as is consistent with sub-paragraphs (a) and (b), the efficient discharge of the licensee's obligations under this licence

The licensee has an obligation to achieve certain objectives, including non-discrimination.

We consider that the proposed modification would end the current discriminatory arrangements, whereby holders of within day and daily interruptible entry capacity contribute significant sums to the capacity neutrality arrangements which are thereafter paid to holders of firm entry capacity.

These arrangements are a significant contributor to the relevant TSRRC. Although the proposed modification does not directly affect the TSRRCs announced by NGGT, approval of this modification would allow NGGT to reduce the entry TSRRC which disproportionately affects holders of within day and daily interruptible entry capacity. The TSRRC also negatively affects holders of long term entry capacity bought after 6 April 2017, as they are subject to the entry TSRRC (unlike those holding 'existing contracts' that do not attract an entry TSRRC).

The result of the current arrangements is that different users face very different costs for the same service of gas transmission. Some users are currently being paid to use the NTS, while others face very high costs. These differences are not objectively justified and are not based on informed commercial decisions but they are the unintended consequence of the capacity neutrality mechanism. UNC748 will reduce - to some extent

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- the unjustified price differential that different users face, by ending: the distortive redistribution of revenues to holders of firm entry capacity; and addressing one key cause contributing to the TSRRC.

For these reasons, we conclude that UNC748 furthers UNC objective (c).

UNC objective (d) so far as is consistent with sub-paragraphs (a) to (c) the securing of effective competition: (i) between relevant shippers;

CMRO (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

The current operation of the capacity neutrality arrangements, whereby holders of within day and daily interruptible entry capacity pay significant amounts (£15m/month) which are thereafter paid to holders of firm entry capacity, has adverse consequences for competition. In addition, the current arrangements are unduly discriminatory, as explained under UNC objective (c).

The continuation of the current arrangements would maintain the distortive redistributional effects of the capacity neutrality mechanism whereby one category of network users cross-subsidises another category of network users (often users with whom they compete). Removing these cashflows from this mechanism prospectively will reduce the scale of the entry TSRRC (which is levied on some but not other network users) and would stop these undue cross-subsidies, which have an adverse impact on shipper competition, on a prospective basis.

The proposed one-off revision to be made by NGGT will reduce substantial unanticipated redistribution effects that have arisen from the capacity neutrality anomaly and the entry TSRRC which has been announced for 1 February 2021.

For these reasons, we consider that implementation of UNC748 furthers UNC Objective (d) and CMRO (c).

UNC Objective (e) Provision of reasonable economic incentives for relevant suppliers to secure that the domestic customer supply security standards … are satisfied as respects the availability of gas to their domestic customers

A respondent indicated that the TSRRCs announced by NGGT on 30 November 2020 are a barrier to gas entering the GB market and are likely to result in higher wholesale gas prices in GB. Another respondent noted that the reduction of the entry TSRRC would reduce the negative impact on security of supply of the announced implementation of TSRRCs on 1st February 2021. Also, a number of respondents stated that the already announced TSRRCs may lead to early withdrawal of gas from storage facilities.

We do not consider that the current arrangements are a risk to security of supply. But we consider that implementation of UNC748 would reduce barriers to entry for gas being shipped to GB and would mitigate the risk of early withdrawals of gas from storage facilities.

We consider that the reduction of the entry TSRRC will enhance competition by reducing costs of marginal supplies. This will facilitate gas being shipped to Great Britain and have a positive impact on security of supply.

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We conclude that UNC748 better facilitates UNC Objective (e).

UNC Objective (f) so far as is consistent with sub-paragraphs (a) to (e), the promotion of efficiency in the implementation and administration of the network code and/or the uniform network code

We consider that the current treatment of interruptible and within day firm entry capacity within the capacity neutrality arrangements is not justified.

The removal of these items from capacity neutrality arrangements will allow the cashflows generated by these items to be treated as collected revenue. This will address one of the key causes of NGGT's revenue under-recovery which have led (and may lead in the future if left unaddressed) to unforeseen high TSRRCs applied by NGGT. As a result, the proposed change will reduce - to some extent - the volatility and unpredictability of charges this year (by allowing NGGT to reduce the already announced TSRRC) and on an enduring basis. Therefore, UNC748 will have a positive impact on the implementation of the charging methodology set out in the UNC. We also consider that the proposed opportunity for NGGT to revise the already announced TSRRCs with short notice is justified, as it is a one-off opportunity to remedy a significant source of market disruption and does not propose to change the notice requirements contained in the UNC on an enduring basis.

For these reasons, we conclude that implementation of UNC748 furthers UNC Objective (f).

UNC Objective (g) 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

CMRO (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

We note that the principles of the Commission Regulation (EU) 2017/460 of 16 March 2017 establishing a network code on harmonised transmission tariff structures for gas (**"TAR NC"**) do not envisage that charges for capacity will be treated other than as part of the allowed revenue. Article 3 TAR NC (Definitions) states that 'transmission tariffs' are the charges payable by network users for transmission services provided to them. It also states that 'transmission services revenue' is the part of the allowed or target revenue which is recovered by transmission tariffs. Article 3 explicitly states that transmission services revenue is one of the revenue components comprising 'allowed revenue'. Therefore, treating interruptible and within day firm entry capacity as part of the allowed revenue is consistent with TAR NC. UNC748, by addressing the capacity neutrality anomaly, would better facilitate compliance with TAR NC.

Also, Article 13(1) of Regulation (EC) No 715/2009 of the European Parliament and of the Council of 13 July 2009 on conditions for access to the natural gas transmission networks (**"Gas Regulation"**) states that tariffs shall be applied in a non-discriminatory manner, shall facilitate efficient gas trade and competition, while at the same time avoiding cross-subsidies between network users and providing incentives for investment and maintaining or creating interoperability for transmission networks. Article 13(2) of the Gas Regulation, also requires that tariffs for network access shall neither restrict market

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liquidity nor distort trade across borders of different transmission systems. We note that TAR NC also sets out similar requirements regarding non-discrimination and preventing undue cross-subsidisation (Article 7(c) TAR NC).

The proposed modification would further the legal requirements set out in the paragraph above. As stated in this letter, UNC748 would remove an undue cross-subsidy from the current arrangements whereby one category of network users cross-subsidises another category of network users (often users with whom they compete). It would also remedy an unjustified discrimination whereby some users pay to use the network and some users get paid to use the network. Furthermore, UNC748 would reduce the cost of entry capacity going forward and would allow NGGT to reduce the already announced entry TSRRC. This will facilitate cross-border trade and encourage the inter-connection between transmission systems.

Some stakeholders have enquired whether the proposed one-off opportunity for NGGT to revise the TSRRCs with short notice would allow NGGT to update the reserve prices applicable for this Gas Year. In that regard, we note that NGGT has clarified that this one-off opportunity would not be used in relation to reserve prices.[22] We also note that under TAR NC reserve prices are binding for the entire Gas Year, therefore NGGT would not be able to amend reserve prices through a UNC modification proposal.

Finally, some respondents were concerned about the predictability of the TSRRCs (entry and exit) that NGGT announced on 30 November 2020. We note that TAR NC stresses the need for transparency and price stability and we encourage NGGT to produce accurate forecasts regarding capacity bookings to support stable prices. The TSRRCs announced on 30 November, in particular the entry TSRRC, are significant and have the potential to negatively impact the market. Some respondents to the consultation and Panel members expressed concerns that UNC748 would allow NGGT to revise the announced TSRRCs with a very short notice[23]. To address these concerns, we ask NGGT to provide as much notice to industry as possible when revising the TSRRCs. Notwithstanding these concerns, overall we consider that the enduring benefit of the capacity neutrality change and the reduction of the already announced TSRRCs justify a limited opportunity for shorter price notice to remedy a significant source of market disruption which can only be exercised once and only shortly (within 2 months) after UNC748 is approved. We stress the need for NGGT to exhaust all possibilities to provide to industry as much notice as possible.

For these reasons, we conclude that UNC748 better facilitates UNC objective (g) and CMRO (e).

Our principal objective and statutory duties

[22] On 15/12/2020, NGGT circulated an 'additional clarification' through the Joint Office of Gas Transporters stating: *"if this Proposal is implemented it is not National Grid's intention to revise all Transportation Charges and we can confirm that we will not issue a notice of revision to the Capacity Reserve Prices applicable for the remainder of the current Gas Year. We acknowledge that such action would be contrary to the requirements of Article 12 of EU Regulation 2017/460 and therefore the only charges within scope of amendment in reduced timescales should Modification 0748 be implemented are those charges utilised for the purposes of within year revenue recovery only"*.

[23] UNC748 states that: "Update of the updated Transportation Charge rates will take effect at the earliest opportunity with a notice period of less than 2 months and no less than 5 business days".

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We have considered the modification proposals in respect of our principal objective and statutory duties. The Authority's principal objective is to protect the interests of existing and future consumers in relation to gas conveyed through pipes.

UNC748 will reduce redistributions that have an adverse effect on competition. Overall, it will reduce the cost of entry capacity and will allow NGGT to reduce the already announced entry TSRRC. Therefore, implementation of UNC748 will benefit consumers.

We also have duties to licence holders to secure that they can finance their licensed activities.[24] UNC748, by removing a significant source of NGGT's revenue under-recovery on an enduring basis, is consistent with our duties.

For these reasons, we have concluded that directing that the modification be made is consistent with our principal objective and statutory duties

Implementation date

UNC748 states that: "the implementation date will be as directed by the Authority".

We note that the substantial cashflows into capacity neutrality will continue unless the proposal is implemented. We also note that NGGT has indicated that implementation could only take place on the first day of a month.

We have decided that UNC748 shall be implemented from **1 January 2021**.

Decision notice

In accordance with Standard Special Condition A11 of the Gas Transporters licence, the Authority hereby directs that modification proposal UN748: 'Prospective Removal of Entry Revenue from Capacity Neutrality Arrangements' be made, in accordance with the implementation date directed above.

Andrew Self
Deputy Director, Energy System Management & Security
Signed on behalf of the Authority and authorised for that purpose

[24] See Authority decision on UNC726 'COVID-19 Liquidity Relief Scheme' (24th June 2020), page 8 https://www.ofgem.gov.uk/publications-and-updates/authority-decision-unc726-covid-19-liquidity-relief-scheme

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