Modification proposal:	**Uniform Network Code (UNC) 765: New retrospective debit and credit charges to reflect changes to the treatment of Entry Capacity Revenue between October and December 2020 (UNC765)**		
Decision:	The Authority[1] has decided to reject this modification[2]		
Target audience:	UNC Panel, Parties to the UNC and other interested parties		
Date of publication:	28 January 2022	Implementation date:	n/a

Background

The Capacity Neutrality arrangements redistribute specific costs and revenues across entry users. Between 1 October 2020 and 31 December 2020, the operation of Capacity Neutrality and Licence arrangements led to significant cashflows being redistributed across entry users and not contributing to Transmission Owner Recovered Revenue.

On 23 December 2020, we approved UNC748: Prospective Removal of Entry Capacity Revenue from Capacity Neutrality Arrangements (UNC748) which removed the charges paid by Users for daily interruptible and within day entry capacity from Capacity Neutrality on a prospective basis. In our UNC748 decision,[3] we said that the treatment of interruptible and within day firm entry capacity within the Capacity Neutrality arrangements was inappropriate. UNC748 was implemented on 1 January 2021. The changes implemented by UNC748 did not affect the charges already paid by Users for daily interruptible and within day entry capacity between 1 October 2020 and 31 December 2020.

[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] UNC748 Prospective Removal of Entry Capacity Revenue from Capacity Neutrality Arrangements: Decision (23 December 2020) https://www.ofgem.gov.uk/publications/unc748-prospective-removal-entry-capacity-revenue-capacity-neutrality-arrangements-decision

The modification proposal

The purpose of the modification is to create new debit and credit charges to recover and re-distribute the revenues received from daily interruptible and within-day obligated Entry Capacity from Capacity Neutrality arrangements between 1 October 2020 and 31 December 2020.

The debit charge would recover part of the Capacity Neutrality revenues distributed to Shippers during the relevant period. The credit charge would redistribute these revenues to all holders of Fully Adjusted Available Entry Capacity between 1 February 2021 and 31 September 2021. Shippers would receive credit proportional to their capacity holdings.

UNC Panel[4] recommendation

At the UNC Panel meeting on 21 October 2021, 13 out of 14 present members of the UNC Panel considered that UNC765 would not better facilitate the UNC objectives and the Panel therefore did not recommend its approval. Neither of the panel members representing consumers, the Consumer Voting Member and the Non-Domestic Consumer Voting Member, voted to recommend implementation.[5]

Our decision

We have considered the issues raised by the modification proposal and the Final Modification Report (FMR) dated 21 October 2021. We have considered and taken into account the responses to the industry consultation on the modification proposal which are attached to the FMR.[6] We have concluded that:

- implementation of the modification proposal will not better facilitate the achievement of the relevant methodology objectives of the UNC.[7]

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[4] The UNC Panel is established and constituted from time to time pursuant to and in accordance with the UNC Modification Rules.
[5] https://www.gasgovernance.co.uk/sites/default/files/ggf/2021-10/Determinations%20Record%2021%20October%202021.pdf
[6] UNC modification proposals, modification reports and representations can be viewed on the Joint Office of Gas Transporters website at www.gasgovernance.co.uk
[7] As set out in Standard Special Condition A11(1) of the Gas Transporters Licence: https://epr.ofgem.gov.uk//Content/Documents/Standard%20Special%20Condition%20-%20PART%20A%20Consolidated%20-%20Current%20Version.pdf

- directing that the modification be made would not be consistent with our principal objective and statutory duties.[8]

Reasons for our decision

We consider this modification proposal will not better facilitate UNC Relevant Code Objectives (ROs) (c) and (d) and UNC Charging Methodology Relevant Objectives (CMROs) (a), (b), and (c), and has a neutral impact on the other relevant objectives. Given the similarities between the applicable UNC objectives, we assess them in tandem.

Objective (c) Efficient discharge of the licensee's obligations and CMRO (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

We believe that the proposal does not better facilitate and would have a negative impact on RO (c) and CMRO (a).

The Proposer argues that the mechanism outlined in the Proposal would recover and redistribute Capacity Neutrality payments made between October and December 2020 in a way that is more equitable than that resulting from the previous arrangements. They state that this is in line with the principles of UNC748, namely that the Capacity Neutrality payments made during this period placed an excessive burden on some shippers. They also state that implementation of the Proposal avoids recovering Allowed Revenue by an alternative method, such as adjusting published charges, which they say is in accordance with their obligations under Special Standard Condition A5 of the Gas Transporter Licence.[9] For these reasons, they argue that the Proposal would further both RO (c) and CMRO (a).

Most Panel Members considered that UNC765 would have a negative impact on RO (c) and said that the negative impacts of retrospective action would outweigh any benefits against ROs. When discussing this during Workgroup, participants questioned the merits of the

[8] 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.
[9] https://epr.ofgem.gov.uk//Content/Documents/Standard%20Special%20Condition%20-%20PART%20A%20Consolidated%20-%20Current%20Version.pdf

proposal, arguing that the introduction of new charges would be effectively solving one market distortion with another, and that the proposal would result in disruption to the market. It was also suggested that any proposed solution would be too late as any impact on shippers of the increased Capacity Neutrality payments will have already been passed on to consumers. The retrospective nature of the proposed charges caused the most concern amongst industry parties. One consultation respondent stated that retrospective changes are likely to bring "insecurity and instability to the market", a sentiment that was echoed by most respondents and workgroup participants.

The Authority recognises that retrospective modifications can introduce uncertainty to the market and so there needs to be strong evidence that the benefits of any proposed action will sufficiently outweigh the potential risks. With regard to UNC765, it is clear that the distribution of Capacity Neutrality payments between October and December 2020 resulted in inequities amongst shippers and that the cost for entry capacity in Gas Year 2020/21 may have increased as a result. While we accept that the proposal would redistribute funds within the Shipper community to address the distortions caused by the operation of Capacity Neutrality arrangements between 1 October 2020 and 31 December 2020, it is not clear to what extent any lower costs will be passed on to consumers.

So, while the Authority does recognise the value in attempting to redistribute the funds in a more equitable manner, the benefits of implementing the Proposal do not outweigh the potential costs in reduced market efficiency. As such, we consider the impact on RO (c) and CMRO (a) to be negative.

Objective (d) Securing of effective competition between relevant shippers and 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

We believe that, on balance, the proposal does not better facilitate RO (d) and CMRO (c).

The Proposer argues that by correcting the impacts of the increased Capacity Neutrality payments through more equitable distribution, effective competition will be enhanced. They state that arrangements in place from October to December 2020 did not effectively target costs incurred by the Proposer.

With the exception of the Proposer, no party said that the proposal would be beneficial to competition in response to the consultation. However, many shippers raised the issue of contractual certainty when considering competition, which they said the Proposal would undermine through the application of retrospective action. One Shipper noted that "the magnitude of the redistribution proposed in the Modification does not appear to warrant the use of retrospectivity". This view was supported by Panel Members, including the Domestic Consumer Representative who submitted the following statement,

> *"That overall this Modification does not clearly demonstrate that the application of credit and debit charges would bring about consumer benefits that would not be outweighed by the impact of perceived regulatory risk. We agree with Ofgem's assertion that it is appropriate to consider any retrospective modifications on a case-by-case basis and believe it is important to test these criteria. On this occasion we do not believe the criteria for retrospection have been met and consider it negative against relevant objective D. However, Ofgem should also consider the overall impact on consumers, including through additional costs as a result of the £47million cross-subsidy arising from the unintended consequences of capacity neutrality arrangements, and how such impacts can be avoided in the future."*

Panel members were in agreement that the implementation of this modification did not support RO (d) and CMRO (c).

The distribution of Capacity Neutrality payments during the relevant period resulted in unintended winners and losers in the shipping community. As a result, there was likely a negative impact on fairness and effective competition caused by the operation of Capacity Neutrality arrangements in the relevant period. While we agree with the Proposer that the charges would compensate some shippers losses to a degree, we also recognise that the regulatory uncertainty introduced through retrospective modifications could be detrimental to competition. It is also not clear that the proposal meaningfully corrects the competition impacts of the inappropriate payments as these may already have been passed through. Therefore, on balance, we believe the Proposal would not further the aims of RO (d) and CMRO (c).

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

We believe that the Proposal would have no impact on RO (g).

The Proposer stated that the proposed charges would ensure that the revenue recovery arrangements from October to December 2020 were more aligned with the 'principles relating to the purposes of the Reference Price Methodology and the [Transmission Services Revenue Recovery Charge (TSRRC)]'. They also argued that the revised arrangements will be more aligned with the requirements of non-discriminatory arrangements and avoiding cross-subsidies, detailed in the Gas Regulation[10].

In Workgroup, participants questioned how retroactively aligning with regulation can be considered to positively impact compliance, while others suggested that correcting mistakes once identified is preferable. Some Panel Members said that RO (g) was not furthered due to the negative impacts they considered the modification would have on competition.

The setting of TSRRCs is set out in the UNC,[11] but it is not entirely clear how the Proposal affects this. Furthermore, in our 23 December 2020 open letter,[12] we said that NGG should avoid the use of TSRRCs where possible, noting the importance of price stability and predictability.

In our decision for UNC748, we said UNC748 would further Article 13(1) of the Gas Regulation and Article 7(c) of TAR NC as we considered that UNC748 "would remove an undue cross-subsidy from the current arrangements whereby one category of network users cross-subsidies another category of network users" and would also "remedy an unjustified discrimination whereby some users pay to use the network and some users get paid to use the network". While we consider that the distribution of Capacity Neutrality payments between 1

[10] 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, now incorporated in UK law in accordance with the European Union (Withdrawal) Act 2018 as amended by the European Union (Withdrawal Agreement) Act 2020.
[11] UNC, Transportation Principal Document Section Y (Charging Methodologies) PART A-I §3 (TRANSMISSION SERVICES REVENUE RECOVERY CHARGES)
[12] See Open letter to National Grid Gas Transmission on Transmission Services Revenue Recovery Charges (23 December 2020) https://www.ofgem.gov.uk/publications/open-letter-national-grid-gas-transmission-transmission-services-revenue-recovery-charges

October 2020 and 31 December 2020 gave rise to an undue cross-subsidy and unjustified discrimination, the proposal does not demonstrate that UNC765 would remedy the impacts of Capacity Neutrality arrangements between 1 October 2020 and 31 December 2020, as noted previously under Objective (d). Therefore, we do not consider that this modification has an impact on RO (g) and CMRO (e).

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

We believe that, on balance, the proposal does not better facilitate, and would have a negative impact on, CMRO (b).

The Proposer stated that by applying charges retrospectively, this modification will effectively correct arrangements from 1 October 2020, the date after which significant cashflows were being subject to Capacity Neutrality arrangements. By doing so, the Proposal will have better taken account of developments in the transportation business during the relevant period.

Workgroup participants stated that the developments seen during this period were actually a change in Shipper behaviour, one which could have been foreseen. Another participant noted that the significant development was the move from zero pricing to a significant price change for capacity, which was not necessarily a development in the transportation business.

As previously stated, we think that UNC765 would address the inappropriate outcomes of the operation of Capacity Neutrality arrangements during the relevant period, but that it is unclear that this would be effectively and fairly passed on to consumers. Further, implementation of this modification proposal would lead to potential negative impacts on the market, as previously stated.

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 and electricity conveyed by distribution or transmission systems. Additionally, Ofgem has published guidance on retrospective regulation which is discussed below.

As outlined in the guidance, retrospectivity is considered on a case-by-case basis, but generally the Authority believes that its use in relation to charging should be exceptional and needs-based. In this instance, the Proposer has not adequately shown that consumers will benefit from the implementation of UNC765. Alongside this, the risk and potential costs resulting from its implementation have been well demonstrated by stakeholders. On balance, the Authority believes that the benefits to consumers have not been shown to outweigh the costs of taking retrospective action.

Assessment against guidance on retrospective modifications

The Authority has published guidance on code modification urgency criteria where we comment on retrospective proposals.[13] In general, we consider that retrospective modifications should be avoided due to the negative impact on market confidence. However, there may be exceptional circumstances that can justify a modification with a retrospective effect. The guidance provides the following examples:

'We consider that it is appropriate to consider any retrospective modifications on a case by case basis, though the particular circumstances that could give rise to the need for a retrospective change could, for instance, include:

- *a situation where the fault or error giving rise to additional costs or losses was directly attributable to central arrangements;*
- *combinations of circumstances that could not have been reasonably foreseen; or*
- *where the possibility of a retrospective action had been clearly flagged to the participants in advance, allowing the detail and process of the change to be finalised with retrospective effect'*

On balance, we consider that the circumstances surrounding this modification proposal do not justify approving retrospective changes. As explained above, it is unclear that any savings arising from UNC765 would be effectively and fairly passed on to consumers. In addition, implementation of this modification proposal would lead to potential negative impacts on the market, as previously stated.

[13] https://www.ofgem.gov.uk/sites/default/files/docs/2011/05/ofgem-guidance-on-code-modification-urgency-criteria_0.pdf

We note that the charging methodology is complex and identifying interactions between its various elements is challenging. The Authority encourages NGG to ensure that in the future appropriate diligence is taken when making modifications to the charging methodology.

Decision notice

In accordance with Standard Special Condition A11 of the Gas Transporters licence, the Authority has decided that modification proposal UNC 765: "New retrospective debit and credit charges to reflect changes to the treatment of Entry Capacity Revenue between October and December 2020" should not be made.

David O'Neill
Head of Gas Markets and Systems
Signed on behalf of the Authority and authorised for that purpose