

Modification proposal:	<b>Uniform Network Code (UNC) 779: Introduction of Entry Capacity Assignments (UNC779); and Introduction of Entry Capacity Assignments with Defined End Date (UNC779A)</b>		
Decision:	The Authority <sup>1</sup> has decided to reject this modification <sup>2</sup>		
Target audience:	UNC Panel, Parties to the UNC and other interested parties		
Date of publication:	11 November 2022	Implementation date:	n/a

## Background

On 19 January 2009, Ofgem approved UNC195AV which introduced reform of the booking arrangements for Exit Capacity on the National Transmission System ("NTS").<sup>3</sup> These arrangements facilitated the assignment of Enduring Annual NTS Exit (Flat) Capacity and Annual NTS Exit (Flat) capacity between users.

On 28 May 2020, we approved modification proposal UNC678A – 'Amendments to Gas Transmission Charging Regime (Postage Stamp)'<sup>4</sup> which was implemented on 1 October 2020. UNC678A introduced far-reaching changes to the Great Britain ("GB") gas transmission charging arrangements and ensured compliance with Commission Regulation (EU) 2017/460 of 16 March 2017 establishing a network code on harmonised transmission tariff structures for gas ("TAR NC").<sup>5</sup>

<sup>1</sup> 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.

<sup>2</sup> This document is notice of the reasons for this decision as required by section 38A of the Gas Act 1986

<sup>3</sup> UNC195AV: Introduction of Enduring NTS Exit Capacity Arrangements (19 January 2009) <https://www.ofgem.gov.uk/publications/unc195av-introduction-enduring-nts-exit-capacity-arrangements>

<sup>4</sup> Amendments to Gas Transmission Charging Regime: Decision and Final Impact Assessment (UNC678/A/B/C/D/E/F/G/H/I/J) (28 May 2020) <https://www.ofgem.gov.uk/publications/amendments-gas-transmission-charging-regime-decision-and-final-impact-assessment-unc678abcdefghij>

<sup>5</sup> Now incorporated in UK law by the European Union (Withdrawal) Act 2018 and the European Union (Withdrawal Agreement) Act 2020, as amended by Schedule 5 of the Gas (Security of Supply and Network Codes) (Amendment) (EU Exit) Regulations SI 2019/531.

Under the current arrangements, when Users have booked Entry Capacity that they no longer require they can either trade the capacity to another User whilst retaining the liability, or surrender the capacity back to NGG via voluntary discontinuance.<sup>6</sup>

## **The modification proposals**

On 19 August 2021, National Grid Gas (“NGG”, “the Proposer”) raised UNC779: ‘Introduction of Entry Capacity Assignments’. The stated aim of this modification is to enable Users to transfer, in full or in part, both the capacity and an associated financial liability at an Aggregated System Entry Point (ASEP) to emulate the assignment of capacity currently available for Users at Exit Points.

On 16 September 2021, RWE (“the Alternative Proposer”) raised UNC779A: ‘Introduction of Entry Capacity Assignments with Defined End Date’ as an alternative to UNC779. This modification aims to introduce a capacity assignment arrangement that also assigns capacity and associated financial liability at an ASEP. It also provides the ability to assign capacity, both full and in part, for a defined period within the duration of a contract by specifying any start and end date, with no minimum assignment period.

Both modifications necessitate changes to NGG’s Gemini System<sup>7</sup> that would provide Users with the ability to assign Entry Capacity and liability. However, the modifications propose differing solutions including, but not limited to: the length of the notification period before capacity assignment, the inclusion or exclusion of weekly capacity, and whether or not the capacity start and end date of the assignment is defined.<sup>8</sup>

## **UNC Panel<sup>9</sup> recommendation**

At the UNC Panel meeting on 17 February 2022, Panel members considered unanimously that both UNC779 and UNC779A (“Modification Proposals”) would better facilitate the UNC

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<sup>6</sup> Voluntary discontinuance is only applicable for Users in certain circumstances. For example, when a User wishes to leave the market.

<sup>7</sup> The Gemini System is a suite of online applications for managing the transportation of gas through the NTS.

<sup>8</sup> More information on the proposed solutions can be found in the Final Modification Report (“FMR”), see:

[https://www.gasgovernance.co.uk/sites/default/files/ggf/book/2022-02/Final%20Modification%20Report%200779\\_0779A%20v2.0%20with%20Reps%20appended.pdf](https://www.gasgovernance.co.uk/sites/default/files/ggf/book/2022-02/Final%20Modification%20Report%200779_0779A%20v2.0%20with%20Reps%20appended.pdf)

<sup>9</sup> The UNC Panel is established and constituted from time to time pursuant to and in accordance with the UNC Modification Rules.

objectives and therefore recommended their implementation. A further 'preference' vote was taken by the Panel to decide which of the two modification proposals would better facilitate the achievement of the Relevant Objectives. The Panel voted that UNC779A better facilitates the achievement of the Relevant Objectives, with 7 votes in favour of UNC779A, 2 votes in favour of UNC779, and 5 Panel Members not expressing a preference.

Of the members representing consumers, both the Consumer Voting Member and Non-domestic Consumer Voting Member voted to recommend implementation, with both casting a 'preference' vote for UNC779A.<sup>10</sup>

## Our decision

We have considered the issues raised by the modification proposals and the FMR dated 17 February 2022. We have considered and taken into account the responses to the industry consultation(s) on the modification proposals which are attached to the FMR. We have concluded that:

- implementation of UNC779 and UNC779A would not better facilitate the achievement of the relevant objectives of the UNC;<sup>11</sup> and
- directing that the modifications be made would not be consistent with our principal objective and statutory duties.<sup>12</sup>

## Reasons for our decision

We consider that these modification proposals would negatively impact UNC Relevant Objective ("RO") (d), would have a neutral impact on RO (a) and have no impact on the other relevant objectives.

### ***(a) the efficient and economic operation of the pipe-line system to which this licence relates***

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<sup>10</sup> <https://www.gasgovernance.co.uk/sites/default/files/ggf/2022-02/Determinations%20Record%20Panel%20Meeting%20287%2017%20February%202022.pdf>

<sup>11</sup> As set out in Standard Special Condition A11(1) of the Gas Transporters Licence, see: <https://epr.ofgem.gov.uk/Content/Documents/Standard%20Special%20Condition%20-%20PART%20A%20Consolidated%20-%20Current%20Version.pdf>

<sup>12</sup> 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.

The Proposals would have a neutral impact on RO (a).

The Proposer states that the modification would give Users an alternative to short-term auctions and incentivise long-term bookings. It is argued that this in turn could provide NGG with more reliable long-term booking data, which could lead to better forecasts as well as providing greater accuracy and stability in price setting. Similarly, the Alternative Proposer believes that the modification provides the same positive impact to RO (a). In their consideration of the ROs, Panel members saw both modifications as having a positive impact on RO (a) because Users would have “*greater ability to apply capacity discounts*”, “*greater flexibility to acquire and utilise capacity in the secondary capacity market*”, and “*more efficient utilisation of booked capacity thereby encouraging use of the [NTS]*”. Panel Members did not engage with the arguments of the Proposer and Alternative Proposer regarding the impacts of the modifications on long-term booking data nor the subsequent impact on price setting stated by the Proposer and the Alternative Proposer. We assess the increased uptake of capacity discounts under RO (d) and the section on our principal objective and statutory duties. In the context of these modification proposals, the key question under RO (a) concerns whether the proposed modifications would improve NGG’s ability to operate the NTS through improved data which would feed into NGG’s forecasts. We consider this question below.

When assessing this impact of the modifications, we have noted the notification deadlines of proposed assignments. Under UNC779 the deadline is the fifth Business Day prior to the first day of the assignment, and for UNC779A the deadline is one Business Day prior to the first Day of the Assignment Period. We consider these short notification periods to undermine the alleged benefits of these modifications associated with providing long-term booking data as NGG will not receive enough forewarning of the impending assignment for it to be of any use in their forecasts. This issue is exacerbated under UNC779A due to the even shorter notice period when compared to UNC779. We also note that the Proposer stated the following in their consultation response, “*Whilst NGG believes that the Alternate offers similar benefits, we believe that this is to a lesser extent for Relevant Objective a) due to the inclusion of the short-term, partial period assignment ability, the inclusion of the weekly capacity auction and the shorter notice period. Overall, we feel it is still a positive change towards Relevant Objective a).*”<sup>13</sup>

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<sup>13</sup> The complete UNC consultation response can be found on the Joint Office website here: <https://www.gasgovernance.co.uk/0779>

Overall, we expect that the proposed capacity assignment arrangements under UNC779 and UNC779A would not have a material impact on the operation of the NTS. For these reasons, we consider that UNC779 and UNC779A would have a neutral impact on RO(a).

***(d) so far as is consistent with sub-paragraphs (a) to (c) the securing of effective competition:***

***(i) between relevant shippers;***

***(ii) between relevant suppliers; and/or***

***(iii) between DN operators (who have entered into transportation arrangements with other relevant gas transporters) and relevant shippers***

The Proposals would have a negative impact on RO (d).

Both Proposers state that their modifications would positively impact RO (d) as Users would have more flexibility and confidence in the management of Quarterly and Monthly Capacity. They argue that this will offer Users another option when acquiring or disposing of primary capacity at an ASEP within relatively short timescales and reduce over-reliance on the short-term markets. Panel Members agreed with this in their assessment of the ROs, further stating that the modifications also enable Users to benefit from the potential discounts associated with holding both the capacity and liability simultaneously.

The proposed modifications state that where the assigned entry capacity qualifies as an "Existing Contract" within the meaning of Article 35 TAR NC (ie long-term entry capacity contracts booked before April 2017 which were grandfathered under Article 35 TAR NC and are subject to a fixed price), the existing contracts protections would be lost post assignment. Existing contracts are on average significantly cheaper compared to 'new capacity' (ie entry capacity not protected by Article 35 TAR NC and which is therefore subject to a floating price).<sup>14</sup> Protections for existing contracts have led to a dual regime in the GB charging methodology where Users face significantly different costs for capacity depending on their access to existing contracts.

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<sup>14</sup> NGG provided estimates in the context of UNC790 that in October 2021 new capacity was on average 23 times more expensive than existing contracts.

In light of the benefits that existing-contract holders have access to, we expect that Users would usually continue to use the existing trade and transfer arrangements to transfer entry capacity associated with existing contracts in order to retain the fixed price of the capacity contracts. We further expect that Users would only use the proposed capacity assignment arrangements in specific cases, for instance where the price of new capacity would be cheaper than the fixed capacity price of an existing contract. This would be possible at entry points that can access high discount rates under the Conditional NTS Capacity Charge Discount (“CNCCD” or “short-haul”).<sup>15</sup> There are few ASEPs on the NTS where a short-haul discount would provide an Entry Capacity price that is cheaper than an Existing Contract price. Therefore, only a select group of Users would be in a position to benefit from the further reduction to the fixed price of existing contracts under both UNC779 and UNC779A. We have assessed the impact of both modifications on the payable entry capacity tariff at an entry-exit combination (route) which is eligible to receive a high short-haul discount. We found that both UNC779 and UNC779A could lead to a reduction of approximately **53%** in the payable entry capacity tariff when an existing contract can benefit from the short-haul discount which is available to new capacity.<sup>16</sup>

NGG has produced analysis demonstrating estimated cost implications from approving UNC779.<sup>17</sup> NGG has identified the potential of UNC779 to cause a revenue shortfall due to the application of the short-haul discount to existing contracts.<sup>18</sup> In brief, NGG found that between Gas Years 2022/23 and Gas Year 2031/32, UNC779 could cause a revenue shortfall of approximately £100m. We note the discussions at Panel and NGG’s statement in the FMR that their supporting analysis on the impact of UNC779 to the Reserve Price is a “worst-case” scenario that would likely not materialise to the extent detailed. We agree that the abovementioned figure of £100m significantly overstates the revenue impacts of UNC779, which are likely to be significantly lower.

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<sup>15</sup> The applicable short-haul arrangements which were introduced via UNC728B, envisage a varying discount for transmission services charges which falls as the distance increases. Entry-exit point combinations at 0km will attract the highest discount rate of 90%.

<sup>16</sup> The example is based on capacity costs for Gas Year 2023/24. Calculations are done to 4 decimal points. The example is based on the simplified assumption that capacity bookings will equal gas flows. The existing contract price we used for the comparison is based on the weighted average price of existing contracts capacity at the specific entry point.

<sup>17</sup> FMR pages 9-10.

<sup>18</sup> NGG also looked at whether the application of the 80% storage discount at existing contracts at storage site would have a revenue impact but found none. NGG noted, however, that this could change in some scenarios under potential future charging modifications.

We think that UNC779 and UNC779A could allow some Users to continue relying on the fixed price of existing contracts to avoid paying the higher floating price for new capacity, whilst allowing them to selectively forego the fixed-price protection in the specific instances where new capacity is cheaper than existing contracts. We consider that increasing accessibility to discounts on the NTS via UNC779 or UNC779A does not positively impact competition, as the benefits would only be realised by a minority of Users.

In addition to this negative impact on competition, the majority of Users on the NTS would end up paying a higher Entry Capacity Reserve Price as this would need to increase to recover the revenue shortfall caused by the few shippers who would be able to forego the fixed price for a lower floating capacity price. We consider that these problems are more pronounced under UNC779A compared to UNC779, as the shorter notification deadline under UNC779A offers increased opportunities to shippers to optimise their bookings and avail themselves of the increased capacity discounts. We also note that the Proposer said the following in their consultation response, *"National Grid therefore believes that overall, there would be a negative impact on competition and so this Modification is negative in relation to Relevant Objective d)."*

Finally, the Alternative Proposer argues that there is currently a risk of Users bypassing the NTS and that their proposed modification would discourage this. They claim that an 'increased incidence of inefficient bypass' would result in higher Entry Capacity Reserve Prices than the increased accessibility to discounts available through the implementation of UNC779A. We are not convinced by this argument. First, we note that no at-risk routes have been identified by the Alternative Proposer. Secondly, as stated in our UNC678A and UNC728B decisions, the principle of a short-haul discount should be to *"reduce the number of routes which continue to present a credible bypass risk, while minimising the amount of discount that is provided to achieve this"*. When we approved UNC728B, we found that the CNCCD would be effective in disincentivising bypass for the vast majority of routes that we considered to be at risk of bypass without a short-haul discount.

For the reasons set out above we consider that both proposals would have a negative impact on RO (d).

## **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.

Both UNC779 and UNC779A have the potential to lead to a revenue shortfall for NGG. This would be to the detriment of Users of new capacity, as any revenue shortfall would lead to an increase in the price for new capacity. There are two drivers behind this potential revenue shortfall:

- First, where existing contracts lose their fixed price protection and attract a high short-haul discount, this would reduce the revenue that NGG expects to receive through existing contracts. The revenue and capacity associated with existing contracts are known. Under the current charging methodology, the revenue associated with existing contracts is deducted from the target revenue forecast to be recovered via the sale of new capacity. In the instances identified in the previous section, where both modifications would lead to an entry capacity cost lower than the fixed price of existing contracts, this would cause a revenue shortfall for NGG.
- In addition, UNC779 and UNC779A could lead to a further revenue shortfall via capacity displacement.<sup>19</sup> In the instances identified in the previous section, the potential of existing contracts to benefit from short-haul capacity discounts may lead to fewer bookings of new capacity by assignees who would utilise the proposed capacity assignment arrangements.

We consider that the two drivers identified above can lead to some revenue shortfall which would increase the price of new capacity, even though we recognise that it is difficult to quantify the exact magnitude of this increase. This would only benefit a few Users (as shown in the example above), at the expense of the majority of other Users and gas consumers across GB. For these reasons, we consider that directing that either UNC779 or UNC779A be made would not be consistent with our principal objective and statutory duties. We reiterate that the shorter notification deadline under UNC779A exacerbates the potential problem

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<sup>19</sup> On the concept of capacity displacement, see UNC739, UNC817.



identified in this section as it offers increased opportunities to shippers to optimise their bookings and avail themselves of the increased capacity discounts.

### **Decision notice**

In accordance with Standard Special Condition A11 of the Gas Transporters Licence, the Authority has decided that modification proposal UNC779: *'Introduction of Entry Capacity Assignments'* and the alternative proposal UNC779A: *'Introduction of Entry Capacity Assignments with Defined End Dates'* should not be made.

**Charlotte Friel**

**Deputy Director - Market Operations and Signals**

Signed on behalf of the Authority and authorised for that purpose