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Subject : EGEM's response to NTS Charging Discussion Document (NTS GCD)
NTS GCD 13
Impact of Existing Contracts on Transmission Services Charges

Please find below ENI's response to NTS Gas Charging Discussion Document GCD 13.

Introduction

It is disappointing that National Gas Transmission has decided to reopen discussions on the charging methodology for transmission services yet again after the rejection of UNC0790. The NTS Charging Methodology has now been discussed for over a decade without leading to a more stable or predictable regulatory environment.

We would like to highlight that none of the issues which National Gas Transmission has raised in the discussion paper concerning Existing Contracts are new.

- When the current charging regime was introduced, it was well known that Existing Contracts would be paying less for capacity than new contracts. Despite this Mod 678A was approved. In their assessment Baringa stated that "*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*". In the same way, Ofgem noted in the document "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, that "*while we consider that protection of Existing Contracts may 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*".
- The NTS GCD 13 Discussion Paper misses the point by focussing on the supposed 'windfall' for Existing Contracts. The very use of the word 'windfall' is prejudicial as it implies an undeserved reward. Companies often enjoy 'windfalls' as a result of decisions made a long time ago, caused by a change in circumstances. Equally, companies which take long term positions may suffer disadvantages. Existing Contract holders have enjoyed both in the many years since they originally booked the capacity. Companies invested in long-term capacity contracts, thereby giving revenue certainty and stability to National Gas Transmission.

For many years other companies that booked short-term capacity were able to benefit from up to 100% capacity charge discounts and thus paid less and took on less risk by booking short-term only. The change in charging regime has been driven and approved by Ofgem. Hence it is contradictory that National Gas Transmission should now want the regime to be changed due to the concern that companies may be enjoying a 'windfall' when the regime change actually created the very conditions that enable it.

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 and do not undermine competition, as demonstrated by Baringa in 2019 and by Frontier Economics in the Impact Assessment on Modification Proposal 790 in 2021.

The following factors were considered to explain the limited impact of tariff differentials:

- The existence of a secondary market in case of overbooking of capacity, which creates an incentive to sell excess capacity to new entrants, potentially at a discount to the Existing Contracts capacity tariff;
- The gas market dynamics being essentially driven by the random variation in the merit order resulting from the normal variation in the price of gas and the tariff variation for new contracts rather than any cost differential between new and Existing Contracts;
- The decrease of the tariff differential over time as the share of existing bookings in total flows falls.

The impact assessment carried out by Frontier Economics came to the same conclusion as the one previously delivered by Baringa. In substance, it emphasised the opportunity cost borne by the holders of Existing Contracts which eliminates the cost difference between using existing and new capacity, rejecting any detrimental effect on competition. Frontier Economics also noted that if distortions to competition are possible in limited cases in practice, they are unlikely to be material since the NBP gas price significantly outweighs the cost of entry capacity charges and the changes between the current and proposed capacity charges. No additional analysis contradicting these assessments was found in the Ofgem Decision letter on UNC0790 or in the NTS GCD 13 Discussion document. It is therefore difficult to understand the desire to revisit the issue, particularly as it will fall away with the expiry of existing contracts.

These points were already raised in our response to the UNC0790 consultation but none of them have been addressed yet by either Ofgem or National Gas Transmission. We request that they are properly addressed as part of any future discussion on the charging regime.

Additionally, since UNC 790 was rejected, the European gas market has changed significantly due the curtailment of Russian gas flows and their partial replacement by LNG. This has also significantly altered the pattern of gas flows both within GB, between GB and Norway and between GB and the EU.

This new situation has two main consequences:

- Firstly, any price differentials between capacity contracts are now even smaller as a share of the delivered gas price to the UK (see also answer to question 1 of the consultation) than at the time the competition analyses by Baringa and Frontier were conducted. This makes it even less likely that competition between gas shippers or suppliers is harmed by the differentials;
- Secondly, the change in flows and hence capacity bookings may influence National Gas Transmission's revenue recovery and the costs of operating the system. Both factors make it less desirable, and indeed somewhat pointless, to reopen discussions on the price differentials between Existing Contracts and new capacity in isolation. Rather any further change to the charging regime should be based on proper analysis of the new situation.

Therefore, we propose the following:

- National Gas Transmission and/or Ofgem commission(s) a proper independent assessment of the impact of the current arrangements on competition between shippers and suppliers. If the impact is minimal there is no need to continue with the current consultation;
- The assessment of the different options proposed includes a review of their compatibility with the TAR NC. There is no point discussing options that are unlikely to be compliant with the TAR NC as they are likely to be rejected by Ofgem. Therefore, National Gas Transmission should first eliminate options that are unlikely to be compliant. Discussion can then focus only on options that do comply with the TAR NC and other relevant regulations, if any;
- As part of any analysis, National Gas Transmission considers in detail the responses to the consultation on UNC Mod 790 as many of the points it makes in the NTS GCD 13 Discussion document were actually addressed then.

Considering the impacts of ECs:

General assessments by options proposed

<u>Options entailing the creation of a new commodity charge</u>

With regard to the options which entail the creation of a new commodity term (Options 1, 2 and 5), we would like to point out that the problem of compliance with the current text of the UK TAR NC remains unresolved. Indeed, Article 4(3) of the Network Code sets out as basic principle that the transmission services revenue shall be recovered by capacity-based transmission tariffs, calling for a strict interpretation of the exceptions contained in Article 4(3)(a) and (b) which allow commodity-based transmission tariffs to be applied under specific circumstances. More specifically, Article 4(3)(a)(i) enables a flow-based charge to be *"levied for the purpose of covering the costs mainly driven by the quantity of the gas flow"* and Article 4(3)(b)(i) enables a complementary revenue recovery charge to be *"levied for the purpose of managing revenue under-and-over-recovery"*. None of these two conditions is met for any of the options presented.

Option of reviewing Existing Contracts

With regard to the option aiming at reviewing Existing Contracts, their flexibility and usage (Option 3), we consider that a restriction on the possibility to sell capacity on the secondary market would be detrimental to the market by (i) limiting competition in the secondary market for transmission capacity and (ii) removing a flexibility currently offered to network users which allow them to acquire capacity potentially at a discount compared to regulated tariffs. As noted above Baringa concluded that the ability to resell capacity on the secondary market limited the impact of tariff differentials. Removing this ability to resell Existing Contracts capacity would therefore likely worsen any impact.

The implementation of such restriction in absolute terms would also jeopardise the application of certain European provisions containing a right for network users to sell their unused capacity on the secondary market for other legitimate purposes. On this, EU Regulation 715/2009 clearly states in Article 22 that "*each transmission, storage and LNG system operator shall take reasonable steps to allow capacity rights to be freely tradable and to facilitate such trade in a transparent and non-discriminatory manner. Every such operator shall develop harmonised transport, LNG facility and storage contracts and procedures on the primary market to facilitate secondary trade of capacity and shall recognise the transfer of primary capacity rights where notified by system users […]*". Moreover, the above-mentioned Regulation, in its section covering the obligation for the transmission system operator to implement and publish congestion management procedures, explicitly sets the principle that "*network users who wish to re-sell or sublet their unused contracted capacity on the secondary market shall be entitled to do so*" (Art. 16 par. 3(b)).

Option to modify the entry/exit split

With regard to the option considering modifying the entry/exit split (Option 4), it will require a strong justification that goes beyond the issue of Existing Contracts and entails broader benefits for the market, the entry/exit split being an essential part of the reference price methodology.

Option to do nothing

With regard to the option considering doing nothing (Option 6), this option alone complies with the legal requirements of the TAR NC and the UNC. All other options are either non-compliant with the TAR NC or unworkable.

The price differential between existing and new capacity contracts was legally justified and predicted before the new charging regime was implemented. When the current regime was implemented three-and-half years ago, it was endorsed by the regulator because it was fully compliant with the TAR NC and the UNC. The impact of the price differential has been insignificant in the context of the overall market and regulatory environment.

Consultation Questions

Considering the impacts of ECs:

1. <u>Do you agree that Existing Contracts are having a significant impact to Transmission Services Entry Reserve Prices?</u>

   The question is not pertinent. It was well known at the time of the introduction of the current charging methodology that Existing Contracts would have a significant impact on Transmission Services Entry Reserve Prices. The proper question to ask would be whether they are sufficiently harming competition to warrant a change in the charging methodology. The analysis carried out by Baringa and Frontier presented above showed this was not the case. Ofgem clearly believed that there was not a sufficient adverse impact on competition to prevent the implementation of the current methodology. However, circumstances have changed since then in terms of both gas flows and the level of gas prices. We therefore propose that National Gas Transmission and/or Ofgem commission(s) a proper independent assessment of the impact of the current arrangements on competition between shippers and suppliers. If the impact is minimal there is no need to continue with the current consultation. It is our view that any impact on competition will have in fact diminished as entry capacity prices now make up an even smaller percentage of delivered gas prices.

   Moreover, we would like to add the following considerations:

   - The existing capacity is predominantly sold for the winter period when demand for gas is high. However, shippers who hold and use existing capacity mainly during the winter season also need to buy new capacity to deliver gas to the NTS during the summer period. In practice, all shippers hold a collection of different capacity contracts. Therefore, it would be hypothetical to consider what impacts Existing Contracts have on new contracts in a single shipper's portfolio of capacity contracts. In other words, individual contracts in a single shipper's portfolio cannot be in competition with each other. Shippers simply purchase diverse types of capacity contracts in the primary and secondary capacity market that have different prices attached to them;

   - The benefits of lower-priced Existing Contracts can be shared on the secondary capacity market, providing all shippers with an opportunity to diversify their capacity portfolios and, overall, reduce their total capacity costs. As a matter of fact, existing capacity is extensively traded on the secondary market because there is a high degree of overbooked capacity inherited from the old regime and there is demand for secondary capacity in the new regime. Nonetheless, it is worth mentioning that the potential for a lower secondary capacity price is related to the availability of the relevant new capacity tariff products which include a short-haul discount (up to 90%) and an interruptible capacity discount (10%);

- The price of some types of new capacity products is remarkably similar to the price of Existing Contracts. If we compare the Average Utilised EC rate of 0.02 p/kWh (provided by NG) with the capacity prices for the current Gas Year, we can see that the storage capacity price is the same as the Existing Contracts capacity price. We can also see that the price of new capacity that attracts the maximum short-haul discount of 90% is 0.01 p/kWh (which is lower than the Existing Contracts capacity price).

Note that large quantities of Existing Contracts capacity remain unutilised but still contribute to the Transmission Services revenue. This unused capacity is not in any competition with new capacity but still has a positive effect on the Transmission Services revenue. Similarly, new capacity that benefits from a short-haul discount is not in competition with existing capacity because shippers prefer to purchase new capacity instead of buying the existing capacity on the secondary market. This was most evident in Q4 2022 at Bacton when, on average, 30% of gas allocations were supported with new capacity while large quantities of Existing Contracts capacity remained unused.

2. <u>Do you believe there should be some remedy to limit/reduce/remove their influence?</u>

No. Neither Ofgem nor National Gas Transmission has produced any evidence that limiting/reducing/removing the influence of Existing Contracts would improve competition. Different cost structures are common in markets and the fact that some companies have lower costs than others is not a sign that competition is failing. Similarly, ensuring that all companies have the same cost structures does not necessarily improve competition, as other factors are important.

Moreover, the impact of any price differentials is limited because:

- The secondary capacity market in the new regime is fully functional and new entrants to the market have access to Existing Contracts capacity when there is demand for it;
- The price of some types of new capacity products is remarkably close to the Existing Contracts capacity price. This is because tariff variation for new contracts is of a similar order of magnitude as the tariff variation across new and Existing Contracts. This limits any potential effects on the differential between Existing Contracts and new contracts;
- A normal variation in the price of gas creates significant differences in the wholesale cost of gas between different shippers. Because the differential between the new capacity price and the Existing Contracts capacity price is much lower than normal variations in the gas price, the capacity price differential becomes irrelevant. For example, the average SAP price in GY 2020/21 was 2.32 p/kWh while in the following GY, the price increased by 226% to 7.56 p/kWh. In this instance, the gas price increased by 5.24

p/kWh while the maximum capacity tariff differential was only 0.09p/kWh.

3. Should there be any specific treatment of any, different to the status quo, for ECs when considering impacts of changing and how overall they are accommodated and charged in the Charging Methodology?

   No, as there is no clear identified need to change the treatment of Existing Contracts.

   The price differential between Existing Contracts and new capacity contracts was legally justified and foreseen before the new charging regime was implemented. The market participants were well informed about the differential before the new regime was implemented and they have adjusted to it. The impact of this differential has been insignificant in the context of the overall market and regulatory environment, such as high and volatile gas prices, the absence of a short-haul tariff for one year and the disconnect between the Formula Year and the Gas Year that affected Transmission and Non-Transmission charges. These other factors have had a far more significant impact. A new short-haul tariff was introduced two years ago and the implementation of Mod 796 five months ago addressed the disconnect between the Formula Year and the Gas Year. The improvements brought about by these two important changes should be assessed first before any other significant charging regime changes are considered.

Options focussing on TS Entry alone:

4. Do you think any of these options provide a more suitable approach to Transmission Services Charging achieving an objective of more 'fair' competitive TS Entry charges?

   No. Neither Ofgem nor National Gas Transmission has shown that the current charging methodology does not already secure effective competition between shippers and suppliers as required by the Transporters' Relevant Objectives and Transporters' Relevant Charging Methodology Objectives. National Gas Transmission has simply shown that Existing Contracts pay lower capacity charges than other capacity holders, which is not the same as showing that competition is ineffective.

   National Gas Transmission has also not examined whether any of the options would comply with the TAR NC. As this is one of the main reasons why previous attempts to change the charging methodology have failed, it is pointless to discuss options to change if they are unlikely to comply with the TAR NC.

   For the reasons explained above, we believe only Option 6 "Do nothing" is the appropriate way forward. We strongly disagree that any other of the considered options will provide a more suitable approach to the Transmission Services Charging Methodology or achieve an objective of 'fairer' competitive TS Entry charges.

5. Are there any other options or refinements/amendments/specific treatment within these options that should be considered and why?

   We do not think that any of these options should be further considered for the reasons highlighted above.

6. Should there be any additional things to consider (e.g. capacity hand-backs)

   No.

On the broader approach to managing TS Entry charging as part of a bigger objective (e.g. making the UK more attractive to land Gas)

7. Are there merits in reviewing Transmission Services Charging on a broader perspective, recognising that this would encompass Entry and Exit?

   The significant change in flows as a result of the current gas crises and the move to net zero will have significant impacts on the use and hence funding of the natural gas network. National Gas Transmission should focus on how to adapt the charging regime for its medium- and long-term future with the goal of preventing any distortions and cross-subsidies between the different energy vectors.

8. What, if any, objective could this aim achieve?

   Sufficient funding for the gas network to ensure security of supply and a competitive natural gas market as the UK transitions to a net zero economy with the goal of preventing any distortions and cross-subsidies between the different energy vectors.

9. Should a discussion and review of, for example, a change to the 50/50 split be a deliverable for any such review?

   With regard to the option considering modifying the entry/exit split (Option 4), it will require a strong justification that goes beyond the issue of Existing Contracts and entails broader benefits for the market, the entry/exit split being an essential part of the reference price methodology.

Overall

10. Assuming an initial conclusion that something should be done (subject to views) do Stakeholders agree that we should explore:

    c) TS Entry only?

    No.

    d) A wider scope i.e. Transmission Services as a whole?

    As stated above, we do not think that any of these options should be further considered for the reasons highlighted above.

11. <u>Is there anything not covered in this initial review that would be beneficial to take into consideration to facilitate advancing discussions on optioneering selection / direction / development for 2024 and beyond?</u>

As stated above, we do not think that any of these options should be further considered for the reasons highlighted above.

We are currently in favour of a "do nothing" approach given that none of the issues which National Gas Transmission has raised in the discussion paper concerning Existing Contracts were not known when the existing Charging Methodology was adopted. Moreover, the compliance of all other options with TAR NC or any other applicable regulations has not been demonstrated. Similarly, the discussion paper has not shown why the presence of Existing Contracts represents a challenge to competition. **Our support for the "do nothing" option is also based on National Grid's analysis that the majority of Existing Contracts are held at Storage sites from GY 2028/29. New capacity contracts at these sites benefit from an 80% discount which minimises the disparity between new and Existing Contracts. Our view is thus consistent with both Baringa's analysis and Ofgem's own views that the existence of any tariff differential is temporary and diminishing over time.**