

By email

Malcolm Montgomery
National Grid
National Grid House
Warwick Technology Park, Warwick, CV34 6DA

15th February 2019

RE: National Grid Gas' Preliminary Consultation on Capacity Methodologies and Statements

Dear Malcolm,

We welcome the opportunity to offer our opinion and views on the proposed changes described within National Grid Gas' (NGG) preliminary consultation on the Capacity Methodologies and Statements¹.

South Hook Gas Company Ltd (South Hook Gas) manages and owns the primary capacity at the South Hook LNG terminal located at Milford Haven in South Wales. South Hook Gas applied for a PARCA (Planning and Advanced Reservation of Capacity Agreement) in respect of incremental entry capacity for the Milford Haven ASEP on 24th April 2018 and is currently at the end of Phase 1 of such application.

As a general point, we would expect the Entry Capacity Release (ECR) Methodology to provide clarity and certainty for PARCA applicants in order to create a stable and transparent basis for investment in GB infrastructure projects. However, our experience in our application is that the processes and requirements as contained in the current Entry Capacity Release Methodology statement have fallen short in this regard. In response to this a UNC Modification² has been raised by South Hook Gas to insert the Entry Incremental Capacity NPV test into the UNC.

While we welcome the NGG preliminary consultation as an alternative means of addressing our concerns above, and note that the proposed changes to the current methodology represent an improvement from the status quo, from our detailed review we feel that the proposed changes still do not provide enough certainty to promote and facilitate investment into Great Britain.

We have summarised some of our high-level concerns below.

1. Introduction of a 16 quarter minimum requirement for all PARCA applications, without prejudging whether that PARCA is met through existing, substituted or incremental capacity

We are not supportive of the change to introduce a 16 quarter minimum requirement for all PARCA applications irrespective of whether a given application is met through (1) existing or substituted capacity or (2) incremental capacity. We feel that there are separate and distinct principles underpinning the user commitment tests for each of (1) and (2).

The minimum 16 quarter duration for PARCA applications that are met through existing or substituted capacity is required to ensure that the applicant is not moving the capacity from one point to another on a regular basis. Crucially, the user commitment test for PARCAs met through existing or substituting capacity does not require the applicant to satisfy any financial test.

¹ <https://www.nationalgridgas.com/capacity/capacity-methodology-statements>

² UNC Modification 0667 – Inclusion and Amendment of Entry Incremental Capacity Release NPV test in UNC

The principles underpinning the user commitment test for incremental capacity (called the NPV or economic test) are entirely different. The NPV test associated with incremental capacity is intended to assure the financial commitment of the applicant. The PARCA applicant is required to contribute a defined financial amount towards the NTS investment costs associated with the incremental capacity³. This ensures that a proportion of investment costs incurred by NGG are recovered from the applicant, with the remainder share equitably in accordance with the underlying charging methodology. Applying the 16 quarter minimum requirement for incremental capacity does not create consistency between all of the user commitment tests. Rather, this would only make the test associated with incremental capacity more onerous for applicants and thereby potentially create a disincentive for investment.

More generally, we feel that the case for making the processes consistent in this respect has not been adequately made. We strongly believe that implementing any such amendment, given its potential economic impact on applicants, requires clear and objective supporting justification and analysis. In short, the solution must be proportionate, correctly targeted and result in an optimal outcome for the applicant and the wider industry.

In reference to “prejudging” how the PARCA application is going to be concluded, NGG are required pursuant to its Transporter Licence⁴ to consider releasing substitution capacity prior to releasing Funded Incremental Obligated Entry Capacity. If a PARCA application can be met through existing unsold or substituting capacity, there is no need to progress with funded incremental capacity. The PARCA would then be subject to the Entry Capacity Substitution (ECS) Methodology. This is referenced in Paragraph 36 of the ECR Methodology where it states that “To minimise the need for investment, before releasing Funded Incremental Obligated Entry Capacity at an ASEP National Grid will consider opportunities to substitute unsold capacity from another ASEP. In addition, substitution will only be considered if the existing capability of the NTS is insufficient to satisfy requests for additional capacity at an ASEP”. Therefore, there is an existing prescribed decision making process that identifies how the capacity associated with the PARCA application is to be released.

As a result of the above, we disagree that having a different minimum duration for the incremental process would drive inefficient and uneconomic investment in the NTS as the process ensures any substitution solution is identified prior to pursuing Funded Incremental Obligated Capacity. In fact, we believe that imposing an excessive minimum duration results in an uneconomic and inefficient NPV test as this results in users signalling more revenue than is required (please see analysis in Appendix 1). It is worth noting that other inconsistencies currently exist between the user commitment tests and that the preliminary consultation does not propose to resolve these other inconsistencies. For example, the user commitment test for incremental capacity met through substitution or existing capacity is within the UNC⁵ while the user commitment test for incremental capacity is exclusively set out in the Entry Capacity Release Methodology.

In addition, under the existing methodology, only the revenue associated with incremental capacity and any premium (on incremental or unsold baseline) contribute towards the NPV test. As a result of this, where an applicant does not have 16 quarters of incremental capacity signalled (but meets the requirement to signal incremental capacity, as discussed below), it is required to signal additional unsold capacity to meet the 16 quarter minimum requirement. This would always result in revenues being signalled in excess of those required under the NPV test, irrespective of the project cost used. It is counterintuitive that a mechanism designed to optimise the delivery of capacity could result in an outcome

³ Currently 50% of the Estimated Project Value, as calculated in UNC TPD Section Y

⁴ Special Condition 9A -

<https://epr.ofgem.gov.uk/Content/Documents/National%20Grid%20Gas%20Plc%20-%20Special%20Conditions%20Consolidated%20-%20Current%20Version.pdf>

⁵ UNC TPD Section B 1.17.7(c)(ii)

where a user is required to overbook capacity in order to fulfil incompatible investment hurdles. We are concerned that NGG may not be complying with its own Licence requirements to facilitate competition and non-discriminatory access to the network by requiring users to book capacity in excess of their requirements.

Given that these additional bookings do not contribute towards the financial commitment aspect of the NPV test, being only required to satisfy the minimum duration requirement, the imposition of the minimum duration requirement could lead to inefficiencies and uneconomic impacts being driven into the capacity booking system (as there may be no commercial rationale for a PARCA applicant to acquire this excess capacity other than to satisfy the NPV test). This requirement may have a significant impact on the financial modelling underpinning decision-making by potential and existing PARCA applicants, especially when combined with the expected changes to the Gas Transmission Charging Regime⁶ where capacity charges are proposed to have a floating reserve price and an unknown revenue recovery charge on all capacity holdings. This increases the amount of uncertainty and potential cost relating to acquiring incremental capacity and could disincentivise investment in GB.

It is also worth noting that the prices generated from the Gas Transmission Charging Review are based on a cost allocation model and not marginal costs. Therefore, having a minimum duration requirement alongside a cost allocation model could result in different System Entry Points contributing different amounts of revenue which are unrelated to the project costs and seems discriminatory against certain Entry Points on the NTS⁷.

As a result of the above, we do not support the introduction into the NPV test of a minimum duration element of 16 quarters on the grounds of alignment of the user commitment tests. We believe the requirement to signal incremental capacity over a minimum of 4 separate years provides the necessary assurance to NGG of the PARCA applicant's sustained requirement for incremental capacity. If an additional duration element is to be introduced into the NPV test then it should be expected, at a minimum, that all quarters contribute towards the NPV test.

2. Change to the determination of project cost for the purposes of the economic test

We recognise the need to move away from the current methodology used to derive the estimated project costs as the LRMC model is likely to no longer be used following implementation of a Gas Transmission Charging Review modification. We note with some disappointment that, despite NGG having invited comments on the potential introduction of a legacy rule for inflight PARCAs, the preliminary consultation does not contain any intention of introducing such a legacy rule. To be clear, we support the establishment of a legacy rule for inflight PARCAs.

In addition, it is concerning that the proposed adoption of the Generic Revenue Driver Methodology (GRDM) to calculate the project cost does not align with the current PARCA process. Our principal concern here is that any inflight PARCA⁸ would be subject to an unknown cost, as a preferred build option and the subsequent project costs (using the proposed methodology) cannot be provided until at least 12 months into PARCA Phase 2. The PARCA process should provide certainty for both the applicant and NGG, allowing both parties to develop their associated projects in parallel. However, this proposed change would result in a significant amount of financial uncertainty and, by extension, project completion risk for any current or future applicant.

⁶ More detail can be found in UNC Modification 0678

⁷ This is not applicable where a Postage Stamp model is used

⁸ An in-flight PARCA is an entry PARCA that has already entered Phase 2 (and completed the 1st NPV test at the end of Phase 1), but is yet to complete the 2nd NPV test at the end of Phase 2

For the proposed project cost calculation methodology to be implemented appropriately the PARCA process should be amended to allow for the preferred build option to be presented, along with the estimated costs, at the end of Phase 1. In addition, there needs to be greater granularity in the report to allow the parties to identify which works forming part of the preferred build option are necessary for the release of incremental capacity. This will provide the necessary assurance to the applicant that the proposed project costs are to be incurred in respect of the works required to achieve the ultimate objective of the PARCA application and investment decision.

3. Introduction of a capacity price premium for PARCA project requiring incremental capacity

We support the introduction of a capacity price premium which is payable in addition to the reserve price to allow the NPV test to be passed. It is generally accepted that, in contrast to the situation when the current NPV test was first implemented, most NTS users are now no longer booking long term capacity. Therefore, it has become increasingly difficult to pass the NPV test. The concept of a premium is already used within the NPV test for incremental capacity at interconnection points⁹ and therefore we would support the proposal to follow the same approach for domestic incremental capacity release.

4. Introducing a rule to determine the amount of incremental capacity required

While we are generally not supportive of a minimum duration within the NPV test associated with incremental capacity (for the reasons set out in point 1 above) we understand NGG's concerns that using a premium without any minimum duration could result in a scenario where incremental capacity is released uneconomically. As such, we would consider that the introduction of a requirement to signal incremental capacity over a minimum of 4 separate years represents a pragmatic compromise. We believe this is a suitable minimum duration as it ensures there is a sustained commitment for incremental capacity, in contrast to the excessive commitment under the 16 quarter minimum duration as proposed in the preliminary consultation.

We greatly appreciate that NGG has allowed this opportunity for industry to provide comments on its initial proposed changes to the capacity methodologies and statements. We believe the proposed changes to the Entry Capacity Release Methodology go some way to resolve the current issues associated with the incremental capacity user commitment test. However, we remain strongly of the opinion that the issue of inefficient and uneconomic bookings arising from the minimum requirement to signal 16 quarters of capacity must be resolved. In addition, the change to the way project costs are calculated creates a significant amount of uncertainty for current inflight PARCAs unless appropriate legacy protection is established.

We hope this response is of assistance and should you wish to discuss further or have any further questions please contact me on abates@southhookgas.com or +44 (0)20 7234 3505.

Yours sincerely,

Adam Bates

Regulatory and Commercial Analyst
South Hook Gas Company Ltd.

⁹ As per EU CAM Network Code

Appendix 1

N.B. this analysis uses a hypothetical scenario and does not represent the actual booking profiles or estimated project values associated with incremental capacity at either Milford Haven or Isle of Grain. The purpose of this analysis is to compare the results of the proposed solution at Milford Haven and Isle of Grain inclusive and exclusive of a 16 quarter minimum duration.

Analysis Summary

- 1) Due to the minimum duration within ECR Methodology review both Entry Points are required to signal more revenue than required to pass the NPV test due to the additional unsold being required and not contributing towards the NPV test (only incremental capacity and any premium contribute towards it).
- 2) With a 16 quarter minimum duration Milford Haven contributes more revenue than the total estimated project cost.
- 3) Despite the cost of incremental capacity for both Entry Points being the same, Milford Haven contributes higher costs in total than Isle of Grain solely due to the 16 quarter minimum duration and differing CWD prices (which are not calculated based on marginal costs).

Proposal	Entry Terminal	NPV Signal Provided	Cost of Incremental Capacity (not discounted)	Cost of Unsold Capacity Required (not discounted)	Total Cost (not discounted)	Percentage Recovered vs NPV Signal Required
Without 16 quarter minimum duration	Milford Haven	£70,000,000	£80,042,169	£11,466,000	£91,508,169	131%
	Isle of Grain	£70,000,000	£80,154,613	£7,443,800	£87,598,413	125%
Proposal with 16 quarter minimum duration	Milford Haven	£70,000,000	£80,040,917	£79,884,000	£159,924,917	228%
	Isle of Grain	£70,000,000	£80,152,291	£51,861,200	£132,013,491	189%

Assumptions

- Project Cost is £140m, therefore the required amount to be signalled to pass the NPV test is a minimum of £70m
- Reserve Price used are from original 0621 CWD Model
- If required to pass the NPV test a premium has been calculated and added to the reserve price
- Incremental capacity (reserve price and premium) and the premium applied to any unsold contribute towards the NPV test
- Both Entry Terminals have the same booking profile