



Making a positive difference
for energy consumers

All interested parties

Date: 3 February 2021

Email: max.lambert@ofgem.gov.uk

Dear colleague,

Implementing the Capacity Constraint Management incentive as part of the National Grid Gas plc Gas Transporter Licence for RIIO-GT2

Today we are publishing our final RIIO-GT2 licence text for National Grid Gas Transmission (NGGT), which includes an Entry Capacity and Exit Capacity Constraint Management (CCM) incentive.¹ We will promptly review the CCM incentive in light of the changes to the operation of the gas charging regime from October 2020 following the introduction of the UNC modification 678A. If necessary, we will then change the CCM incentive licence text we are publishing today to address the effects of UNC678A on the operation of this incentive.

Background: Changes to NGGT cashflows

Prior to October 2020, short term capacity prices were very low (daily interruptible and within day entry capacity was sold in auctions which had a zero reserve price). Historically, these capacity products contributed low cash-flows into the capacity neutrality mechanism and into the calculation of the CCM incentive. Since 1 October 2020, these capacities have been sold in auctions with a positive reserve price. This has resulted in significantly higher revenues being used in the calculation of the CCM incentive. The CCM incentive is now forecast to reach its maximum cap for regulatory year 2020/21 and it is expected that this will also be the case in 2021/22 under the new CCM incentive

¹ National Grid Gas plc, Gas Transporter Licence, RIIO-2, Special Condition 5.5. Entry Capacity and Exit Capacity Constraint Management (CM_t) [<https://www.ofgem.gov.uk/publications-and-updates/decision-proposed-modifications-riio-2-transmission-gas-distribution-and-electricity-system-operator-licences>]

for RIIO-GT2. This increase in CCM incentive revenues will not be completely driven by the behaviour of NGGT in the management of capacity constraints or in maximising the release of additional capacity. So, there is a need to ensure the CCM incentive fully achieves its intended outcome in the context of changes to the operation of the gas charging regime following the introduction of UNC678A.

The effects of changes to the operation of the gas charging regime following the introduction of UNC678A on the CCM incentive did not become apparent until November 2020. There were also impacts on capacity neutrality and we approved UNC modification proposal **UNC748: Prospective Removal of Entry Capacity Revenue from Capacity Neutrality Arrangements** on 23 December 2020 to address some of these effects from January 2021. However, the functioning of the CCM incentive is outside the scope of UNC748 and so this did not address the potential impacts of UNC678A on the CCM incentive.²

The timing of the RIIO-2 process meant it was not possible to address these impacts in advance of the RIIO-2 Final Determinations in December 2020. As such, having concluded a statutory consultation on implementing the new RIIO-GT2 CCM incentive, it is apparent that the underlying circumstances have changed such that the incentive, in its current form, requires review.

Preserving safeguards for consumers

We have considered if the CCM incentive should be removed from the licence that we are publishing today. However, this would risk exposing consumers to significant costs in the event that a constraint occurred which NGGT had no incentive at all to manage.³ The purpose of the CCM incentive is to deliver an efficient overall cost of NGGT constraint management actions and encourage balanced risk versus reward decisions in the release of additional capacity. The

² This letter does not address the issues in respect of NGGT's revenue under-recovery, which is a separate and distinct issue.

³ See paragraphs 2.30 onwards of Final Determinations which summarises consultation responses on this point [https://www.ofgem.gov.uk/system/files/docs/2020/12/final_determinations_-_nggt_annex.pdf].

licence as it stands still ensures that constraint management actions are incentivised but risks over-rewarding NGGT.

We are therefore implementing the incentive via the licence. We will promptly review the CCM incentive in order to ensure that it will best deliver the protections it is designed to provide for consumers whilst maintaining the right incentives on NGGT.

Intention to review the CCM incentive

The text in the licence that was consulted on provides for the CCM to be reviewed in certain circumstances, e.g. if the cap is reached in two consecutive years or if the collar is reached. We are making a minor change to the review provisions of the licence from the version on which we consulted. This change does not make any substantive alteration to the way in which the CCM incentive works – such changes will need to be the subject of further analysis and consultation in due course. It was always intended that there should be provision for reviewing the incentive if the thresholds were met, and current indications are that this will happen in RIIO-GT2. Our change makes it possible to bring the review forward and address the problem sooner. From preliminary discussions we have had with NGGT, we understand that they agree that the CCM incentive needs to be reviewed.

In line with the licence we are publishing today, we will review the RIIO-GT2 CCM incentive to better align its key aims of protecting consumers whilst balancing the reward available to NGGT in managing risks. We will consult on any subsequent changes to the licence arising from this review in due course. As part of this review, we will specifically consider the date from which any changes to the RIIO-GT2 incentive framework would come into effect. This date may be as early as 1 April 2021.

Yours sincerely,

David O'Neill

Head of Gas Markets and Systems