5 July 2018

To GTAC Workshop Participants c.c. GIC, IF
(via email)

**Open letter to GTAC Workshop Participants – Incentive Charges**

Having considered the GTAC Workshop Plan document dated 29th June 2018 (and the GTAC drafting comments) MGUG still remains seriously concerned at the incentive charge regime. Along with GIC we have raised concerns that the incentive fee structures within the GTAC are not economically efficient. The GIC has noted this by saying that incentive fees appear excessive, especially where the pipeline is unconstrained. Our view is that:

1. Required nomination accuracy (daily and peaking) raises transaction costs for everyone (monitoring, nominating, investing in more systems to improve "accuracy", invoicing etc). We consider the number and level of incentive charges would not satisfy appropriate cost benefit analysis of having them in there;
2. The redistribution mechanism of incentive charges bears little relation to "causer pays" where there has been no cost incurred. It becomes a wealth transfer, which together with information asymmetry will benefit shippers/ retailers.

Our concern has been compounded by the development of the incentive regime which has been something of a moving target – an ever increasing requirement to be more accurate imposed by FG which appears based on an inference that greater accuracy is able to be achieved or hence justify the transaction costs.

In our view we need to ensure that the opportunity is not lost to check the design against the principles that were supposed to shape it. We believe the comments by the GIC (and others on more specific matters) should invite a deeper reflection around incentive designs. Our concern has been reinforced by the papers issued on 3 July 2018 that we should ensure options are assessed against the principles. We suggest that the first workshop considers the issue of "**nomination accuracy**". Our reasoning follows.

Having decided on a DNC regime as the basic design feature of the new code, this also introduced the concept of "nomination accuracy". Surprisingly for all the complexity and problems that this concept has created in the final draft GTAC, the idea of accurate nominations has never been fully discussed. In order to advance the final discussions we want to specifically reflect on the idea of "**accurate nominations**" which underlies much of FG's reasoning for the design of the terms and which has driven the increasing complexity of the final arrangements. This in turn has led to a substantial number of the issues identified by the GIC as being problematic.

By way of background we record our view of the evolution of the increasing complexity of the GTAC.

In **SCOP1** (September 2016) the GIC outlined amongst other matters the conclusions of the PEA work on guidelines for designing a new access regime that could be described as being " (economically) efficient". This included amongst others, the comment "*Include a nominations regime* (*at least for those zones where congestion is possible*) *with incentives for parties to give accurate nominations*". The actual wording of the PEA advice on guiding principles (Advice from Panel of Expert Advisers, July 2013, p6 ) was:

"There is a strong case for moving to a regime where nominations apply for both firm and non-firm services to facilitate efficient scaling when congestion arises. This means nominations would apply at least for those zones on the pipelines where congestion **could potentially arise during the term of the offered capacity contracts**. Furthermore, parties should have an incentive to ensure that **such nominations reflect the best possible information**. One means of achieving this would be for nominations to form the basis for transmission charges." (our emphasis added)

This was an early signal for a capacity nomination regime, but also for a nomination regime that was fit for purpose in terms of required nomination accuracy, specifically **within the term of the offered capacity contracts**. – i.e. possibly just one day ahead, as it turns out in the GTAC

The idea that nominations might not even be necessary was explored further through the alternative design option "*Flow to Demand, with forecasts as required by the TSP*" (**SCOP2**, December 2016). Whilst the practicalities of implementing such a system were carefully considered the idea was dropped primarily for the lack of any overseas examples. SCOP2 also reconfirmed the design principles that the code should; minimise cost of transporting gas, keep the code simple, promote flexibility, and increase transparency. FG also agreed that it should set "efficient prices".

Despite being ruled out of further consideration, the concept of flow to demand at least captured the notion that the TSP is providing a *transmission service*. Part of that service is giving flexibility to end users to manage their uncertainties in their daily demand for transport, as well as keeping arrangements simple for consumers. The flexibility is offered through load diversity and the physical capacity of the transmission assets. The value of that service is captured in the basic transport fee.

In arriving at the first design iteration of DNC product (Emerging Views – May 2017) only the concept of overrun charges was considered to be needed to encourage accurate nominations. A three tier incentive regime was proposed; up to 103% (tolerance, no fee), 103-105% = 5xDNC, 105%+ = 10xDNC. The primary balancing incentives had a similar tiered approach to incentives including a no fee tolerance. This approach elicited reasonably broad support as it seemed to balance the capabilities of the asset with the practicalities of fluctuating intraday demand forecast capabilities of downstream consumers.

Nevertheless the first draft of the GTAC (August 2017) contained a number of surprises around nomination incentives:

1. A new underrun fee
2. Removal of tolerances on under/over run
3. MHQ fees.
4. Overflow charges.

The reasoning for the stricter terms was never adequately explained in our view. They seemed to be based on “possible” but not necessarily “probable” scenarios.  Furthermore there was no reference to any evidence on how nomination incentives that might flow from that were in any way efficient.

Rather these design features have aggravated the issues faced by the mass market in terms of their ability to nominate accurately for their customer base, increased the money flows created from incentive revenues, and increased the potential cost to consumers through asymmetries in the redistribution process of incentive charges.  We now have a proposal where the basic transmission charge captures all of the capped revenue for First Gas, not just for the industry service provided by the pipeline. It also now includes an uncapped revenue gathering and redistribution service with no checks on economic efficiency.

In our view the most productive use of the workshop time is to consider the issue of nomination accuracy more openly before diving into further detail modifications of the draft GTAC.

- Why are they necessary?
- When are they necessary?
- How should they be designed to be service based and cost reflective within the concept of a daily nominated capacity product?

Whilst we believe these are our main issues, there is also an issue of needing appropriate tools to manage nomination risk. This includes consideration of the ID cycles and the need to have the ability to adjust for changes between the last opportunity to nominate and the end of the transmission day. Clearly the importance of this is in proportion to the magnitude of the risk in exposure to high incentive fees. This is why we would try and address the potential magnitude first, but not forgetting the need for more effective nomination tools.

Yours sincerely

Richard Hale/Len Houwers
Hale & Twomey Ltd/Arete Consulting Ltd
Secretariat for the Major Gas Users Group