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The Joint Office, Relevant Gas
Transporters and other interested
parties

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Dear Colleague

**Uniform Network Code modification proposal 013 and 013a "Amendment to Transco's rights to interrupt for supply/demand purposes" (formerly Transco Network Code modification proposals 0740 and 0740a)**

Ofgem[1] has considered the issues raised in the modification report in respect of modification proposals 013 and 013a "Amendment to Transco's rights to interrupt for supply / demand purposes[2]", and having regard to the principal objective and statutory duties of the Authority[3], has decided to direct the relevant gas transporters to implement modification proposal 013a, and not to implement modification proposal 013.

Ofgem considers modification proposal 013a will better facilitate the achievement of the relevant objectives of the uniform network code (UNC), as set out under Standard Special Condition A11 of the relevant gas transporters'[4] licences as compared with the existing provisions of the UNC or the alternative proposal 013.

In this letter, Ofgem explains the background to the modification proposal and gives reasons for its decision.

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[1] Ofgem is the Office of the Gas and Electricity Markets Authority. The terms 'Ofgem' and the 'Authority' are used interchangeably in this letter.

[2] The modification proposals set out in this letter were originally proposed in accordance with the modification rules set out in Transco's network code[2]. Following the implementation of urgent modification proposal 0745 and in accordance with paragraph 2.1 of Part IV of the Transitional Rules, on 1 May 2005 this modification proposal was deemed to be a modification proposal made in respect of the UNC in accordance with the UNC modification rules. On 3 May, the Modification Panel voted to allow the proposal to continue through the UNC modification process without re-consultation and modification proposals 0740 and 0740a were assigned their new numbers.

[3] Set out in Section 4AA of the Gas Act 1986, as amended.

[4] On 1 May 2005, Transco hived down 4 of its Distribution Networks into four wholly Transco owned subsidiary companies in preparation for the sale of these DNs (scheduled for 1 June 2005). On 1 June 2005 the share sale was completed, and the relevant gas transporters are Transco's RDN and NTS businesses and the buyers of the DNs.

**Background to the proposal**

*The role of gas shippers and suppliers in gas balancing*

Transco NTS has two principle roles associated with keeping the system in balance. Transco NTS is responsible for residual gas balancing to the extent that the gas shippers' aggregate inputs and offtakes do not balance at the end of the day across all networks. This residual energy balancing role includes the buying and selling of gas in response to sudden unexpected losses of supply or increases in demand within day (where shippers do not respond). Transco NTS is also responsible for undertaking system balancing actions for constraint management purposes on the NTS.

The UNC provides commercial incentives on gas shippers and suppliers to balance their inputs to, and offtakes from, the system by the end of the day[5]. These incentives are created by the 'cash out' arrangements that set the price that shippers pay for any imbalances at the end of the day. These arrangements are important for ensuring that the market operates to achieve security of supply by providing incentives for gas producers, suppliers and storage operators to contract to meet their customers' demands and to manage the risk of gas supply failures. When Transco NTS in its residual system operator (SO) role undertakes balancing actions it is important that the cost of these actions are reflected in cash out prices so as to provide gas shippers and suppliers with the appropriate incentives to balance their inputs and offtakes from the system.

Transco NTS has a number of tools available to it to allow it to fulfil its residual energy balancing role. Under the current arrangements, one of these tools is the ability to interrupt some customers through contractual arrangements with shippers.

*Interruption contracts*

Users of relevant gas transporters networks, including the NTS, may currently choose to be either a firm user of the relevant gas transporters systems or interruptible user.[6] Where a user chooses to hold an interruptible contract this affords the relevant transporters certain rights. These include the rights to interrupt all or part of that user's demand for:

- constraint management purposes for up to 45 days in any charging year for a standard interruptible supply point;[7]
- for supply/demand balancing if forecast national demand is greater than 85% of the forecast 1 in 20 peak day demand;
- in an emergency; or
- for testing purposes.

[5] Although the network code arrangements only apply directly to shippers, these arrangements are relevant for other parties, such as suppliers, through the contractual and market arrangements in place.
[6] Once a user has elected to have transportation rights on an interruptible basis, relevant gas transporters may currently unilaterally designate an interruptible point (either as Shipper Nominated Interruption (SNI) or as Transco Nominated Interruption (TNI)) as a Network Sensitive Load (NSL). Such loads, by virtue of their location are more likely to be interrupted. NSLs are unable to return to being firm, whereas SNIs can.
[7] TNI supply points may face greater than 45 days interruption.

*Previous modification proposals*

*Modification Proposal No. 0699: "Amendment to Transco's interruption rights for supply / demand purposes".*

Shell Gas Direct (SGD) raised network code modification proposal 0699 "Amendment to Transco's interruption rights for supply/demand purposes" on 19 May 2004. This modification proposal sought to change the limit above which Transco could call for interruption for supply/demand balancing purposes from forecast national demand greater than 85% of the forecast 1 in 20 peak day demand to 90% from April 2005, with a further amendment to 95% from April 2006. The proposer considered that, by removing Transco's right to interrupt at lower demand levels, Transco would be more likely to seek market based options for demand management, i.e. through contracting on the On-the-Day Commodity Market (OCM) or through forward contracting, prior to instructing interruption. The proposer considered that increasing Transco's reliance on the market, would both increase the incentives on Transco to reduce the costs it incurs in energy balancing and ensure that appropriate price signals would be sent to the market, through the cash out mechanism, as to the value of flexibility services.

This proposal was withdrawn by the proposer following Ofgem's decision on modification proposal 0705.

*Modification Proposal No. 0705: "Changing the basis for supply demand interruption".*

Following workstream discussions on modification proposal 0699, Transco raised an alternative network code modification proposal, 0705, "Changing the basis for supply demand interruption." The proposal sought to amend Transco's supply/demand interruption rights by replacing the 85% limit with the ability for Transco to initiate interruption for the purposes of operational balancing (that is, balancing the quantities of gas delivered to and offtaken from the NTS) only where Transco determines that there is an operational balancing requirement which cannot be satisfied by taking any market balancing action (because there are no offers available to Transco which are operationally suitable).

This proposal was rejected by Ofgem on 13 December 2004. Ofgem considered that modification proposal 0705 would not better facilitate achievement of the code relevant objectives as, in summary, Transco had not properly considered the impacts of unilaterally changing the terms on which Transco can call interruption as put forward by the modification proposal. Ofgem also considered that if the proposal was approved, Transco could call interruption for energy balancing purposes more frequently. Under the current arrangements, this could reduce the incentives created through cash out to maintain security of supply.

## The modification proposals

*Modification proposal 013*

Modification proposal 013 was proposed by Shell Gas Direct Ltd on 10 January 2005. This modification proposal seeks to change the limit above which Transco NTS could call for interruption for supply/demand balancing purposes from forecast national demand greater than 85% of the forecast 1 in 20 peak day demand to 95% from October 2005 with a further amendment to 100% from April 2006.

The proposer was of the view that, by restricting further Transco NTS's right to interrupt at lower demand levels, Transco NTS would be required to go to the market through the OCM or advance contracting if it considered this is necessary to ensure supply and demand balancing at the system level. The proposer expressed the view that, by relying on the market, Transco NTS would be properly incentivised to minimise its costs and price signals would be sent to shippers and hence to consumers about the value of their flexibility. The proposer also considered that the approach of increasing the interruption level in increments over a year would be appropriate as it would give sufficient time for consumers, shipper/suppliers and Transco NTS to adjust to the change whilst recognising that there is a risk that some may not be in a position to make changes for the forthcoming winter by the time this proposal is approved.

*Modification proposal 013a*

Modification proposal 013a was proposed by Transco NTS on 10 January 2005. This modification proposal seeks to remove the ability for Transco NTS to interrupt for supply/demand balancing purposes.

The proposer, Transco NTS, was of the view that the implementation of this modification proposal would remove any ambiguity in respect of the responsibilities of users in their primary balancing role and those of Transco NTS in its residual balancing role. By removing the option to call for interruption on days where forecast demand is in excess of 85% of the forecast 1 in 20 peak day demand, the proposer considered that this modification proposal would promote greater competition between users than that which may be achieved through modification proposal 013 as it would reinforce and clarify the responsibilities of the primary balancing role.

## Respondents' views

There were 11 responses to the consultation on modification proposals 013 and 013a. The majority of respondents supported the underlying principle behind both modification proposal 013 and 013a. However, the majority of respondents were of the view that modification proposal 013a would better facilitate the relevant code objectives as compared with modification proposal 013. One respondent offered qualified support for both modification proposals and a further one respondent supported modification proposal 013.

The majority of respondents supported the underlying principle behind both modification proposals to restrict, in the case of modification proposal 013, or remove, in the case of modification proposal

013a, Transco NTS's ability to interrupt for supply/demand balancing reasons. A number of respondents considered that restricting or removing the ability for Transco NTS to interrupt for supply/demand purposes would be consistent with maintaining Transco NTS's role as a residual energy balancer. In support of this view, one respondent considered that restricting or removing the ability for Transco NTS to interrupt for supply/demand purposes would provide greater clarity in regards to the roles and responsibilities of industry parties if the ability for Transco NTS to interrupt for supply/demand purposes was removed in it is entirety.

A number of respondents who supported the underlying principle behind both modification proposals considered that Transco should rely on the market to address supply/demand balancing of the system through use of the OCM. In support of this view, one respondent considered that the balance of supply / demand should be addressed by market based solutions, particularly since the appropriate market mechanisms, primarily the OCM, already exist to support this approach.

A number of respondents that supported the underlying principle behind both modification proposals considered that, whilst Transco NTS has never called interruption for supply/demand balancing purposes, having the knowledge within the market of Transco NTS's ability to do so has suppressed the perceived incentives on shippers to balance. In support of this view, one respondent considered that restricting or removing the ability for Transco NTS to interrupt for supply/demand purposes would bolster market confidence and raise expectations that cash out prices will be allowed to rise to a level that enables parties to economically justify projects that stimulate the provision of both supply and demand side services consistent with meeting peak and non peak imbalances.

One respondent was of the view that restricting or removing the ability for Transco NTS to interrupt for supply/demand purposes should also act as an incentive to encourage suppliers to offer demand side contracts to customers which would, in turn; allow customers increased opportunity to benefit from demand side participation.

The respondent offering qualified support for modification proposal 013a considered that the success of this proposal would depend on the reactions of market participants. The respondent was unsure whether more demand side response would be posted on the OCM, or whether the GB gas market would be more likely to enter into an emergency more quickly than it would previously have been. This respondent was of the view that the changes to Transco's safety case should be seen and understood by the industry and Ofgem before any final decision is made.

One respondent raised concerns that there should be appropriate incentives on Transco NTS to take-up demand-side OCM locational offers. This respondent considered that there is considerable administrative complexity for shippers to establish and maintain these offers and shippers may be reluctant to post these offers on a speculative basis, given Transco NTS's "historically poor track record in taking them". This respondent considered that effective and explicit market notification would be key in this regard, especially until shipper and Transco NTS behaviours adjust.

The respondent in favour of modification proposal 013 considered that this proposal, in proposing a phased approach, better facilitated the change from the current arrangements to a new regime than modification proposal 013a. This respondent considered that 013a warranted merit but considered that a transitional approach would be required to allow shippers to amend and put in place new contracts with their customers in response to the change.

However, the majority of respondents, including Transco NTS, were of the view that there was not a strong case for 'phasing', i.e. increasing the interruption level in increments over a year as put forward by modification proposal 013, and that, in terms of timing, it would be more appropriate to introduce the necessary changes in one step, as put forward by modification proposal 013a. In support of this view, one respondent commented that it was important to ensure that any ambiguity in Transco NTS's balancing actions for supply/demand balancing is removed as soon as possible. A further respondent considered that a phased approach was not appropriate since Transco NTS had never interrupted for supply/demand balancing purposes since the inception of the network code. This respondent therefore considered that it was reasonable to assume that a phased approach was unnecessary since it would merely delay the full removal of Transco NTS's ability to interrupt for supply/demand balancing purposes for one year.

One respondent noted that Transco NTS should consider the legal text associated with modification proposal 0702 "Partial 'volume' interruption" because it would no longer be relevant if modification proposal 013a was approved.

**Transco NTS's view[8]**

Transco NTS was supportive of the underlying principle behind modification proposal 013 but it considered that the full removal of Transco's right to interrupt for supply/demand balancing purposes as put forward by modification proposal 013a would better facilitate the relevant code objectives in comparison with modification proposal 013.

Transco NTS considered that the complete removal of the ability for Transco NTS to interrupt for supply/demand balancing reasons supported the principle that users have the primary balancing responsibility and that Transco NTS's role is to be the residual energy balancer. Transco NTS was of the view that modification proposal 013a would clarify the roles and responsibilities of industry participants and, by feeding all the costs of demand reduction through to cash out prices, would also increase incentives on users to address their primary balancing obligations. In addition, Transco NTS was of the view that modification proposal 013a would reduce the risk of entering a potential gas supply emergency.

Transco NTS acknowledged that, in the short term, it may need to take more demand side residual balancing actions on the OCM if users choose to allow Transco NTS to resolve their imbalances rather than balancing their own positions. However, Transco NTS was of the view that, in feeding all the costs of demand reduction through to cash out prices, modification proposal 013a would incentivise users to balance their own positions in order to reduce their imbalance exposure.

[8] At the inaugural UNC Panel Meeting the Panel chose not to re-consult on this modification proposal. In addition the Panel chose not to make a recommendation on this modification proposal.

Transco NTS was also of the view that if its ability to interrupt for supply/demand balancing reasons was removed it should encourage a variety of commercial interruption contracts, which should lead to a higher level of demand side response on days of high demand and supply deficits.

Transco NTS acknowledged the point raised by one respondent that there should be appropriate incentives on Transco NTS to take-up demand-side OCM locational offers. In response Transco NTS noted that, in recent years, GB had experienced historically mild winters. Transco NTS considered that this, together with prevailing Transco NTS balancing incentives, has contributed to the lower level of locational market actions required by Transco NTS in its roles as residual balancer. Transco NTS recognised that any changes in market behaviour would need some time to adjust and that the provision of a market notification would provide confidence in respect of Transco NTS's intent when it requires locational market actions. Transco NTS was of the view that, should it have a future requirement to take actions in the locational market for supply/demand balancing reasons, it will notify users as soon as such a requirement is identified to allow sufficient time for offers to be placed on the market. Transco NTS stated its intention to notify users of these requirements through the ANS (Active Notification System).

Transco NTS noted the point raised by one respondent that success of either modification proposal would depend on the reactions of market participants in relation to whether the GB gas market would be more likely to enter into an emergency more quickly than it would previously have been if either modification proposal were to be implemented. In response Transco NTS expressed the view that restricting or removing the ability for Transco NTS to interrupt for supply/demand purposes will clarify the roles and responsibilities of industry participants and, by feeding all the costs of demand reduction through to cash out prices, will also increase incentives on users to address their primary balancing obligations. Transco NTS considered that, together, these changes would reduce the risk of entering a potential gas supply emergency.

Transco NTS was mindful of the relationship between these modification proposals and the necessary changes to its Safety Case. Transco NTS is of the view that an approval of either modification proposal 013 or 013a should coincide with an approval of its Safety Case otherwise Transco NTS could be placed in a conflict between its legal and statutory obligations. Transco NTS also considers that modification proposal 013 would require two material changes to the Safety Case.

Transco agreed with the point raised by one respondent regarding the legal text associated with modification proposal 0702 "Partial 'volume' interruption", and stated that it had revised the legal text for modification proposal 013a to include the removal of redundant text associated with modification proposal 0702. Transco stated that the removal of this text does not mean that the flexibility of this service has been removed but rather that this becomes a part of the discussion between users and end consumers with resultant offers being placed by the user on to the OCM.

**Ofgem's view**

Ofgem has carefully considered the views of respondents and Transco NTS in relation to both modification proposal 013 and 013a. As both modification proposals are seeking to address the same concerns, albeit to different timescales, Ofgem has considered which modification proposal, if any, would better facilitate achievement of the relevant objectives as set out in Standard Special Condition A11 in the relevant gas transporters' licences. Having regard to its principal objectives and consistent with views of a majority of respondents and Transco NTS, Ofgem considers that modification proposal 013a would better facilitate achievement of the relevant code objectives compared to modification proposal 013 and the existing UNC baseline.

Ofgem therefore welcomes the view of the market participants and Transco NTS that Transco NTS's ability to interrupt for supply/demand balancing reasons should be restricted, in the case of modification proposal 013, or removed, in the case of modification proposal 013a.

*Standard Special Condition A 11 (a) – the efficient and economic operation of the pipe-line system to which this licence relates*

Ofgem agrees with the majority of respondents and Transco NTS that restricting or removing the ability for Transco NTS to interrupt for supply/demand purposes would be consistent with maintaining Transco NTS's role as residual energy balancer and would provide greater clarity in regards to the roles and responsibilities of Transco NTS and the market. Further, Ofgem considers that, consistent with the views of a number of respondents and Transco NTS, restricting or removing the ability for Transco NTS to interrupt for supply/demand purposes, will require Transco NTS to use the market as the primary tool to address supply/demand balancing of the system through, for instance, use of the OCM. As a general principle, Ofgem considers that it is a matter for Transco, as SO, to determine the appropriate structure for its contracts for both system and energy balancing, consistent with its obligations to operate the system in an economic, efficient and coordinated manner.

Under the current arrangements there may be confusion over the respective roles of shippers and Transco in balancing the market. The current rules provide Transco with the option to interrupt a potentially significant volume of demand under certain demand conditions. The existence of these contracts blurs the distinction between Transco's role and shippers' roles in balancing the system. Any confusion that may exist over the circumstances in which Transco may call interruption for demand/supply purposes may undermine the commercial incentives that shippers face to balance their inputs and offtakes.

Ofgem agrees with respondents and Transco NTS that this will make sure that cash out prices properly reflect any costs that Transco incurs in using the demand side in its role as residual balancer. This will improve the incentives on users to address their primary balancing obligations. If these costs are not appropriately fed into the cash out price calculations, there is a risk that the use of these contracts may dampen the commercial incentives created by the cash out arrangements to promote security of supply. Transco's existing contracts are effectively structured with a zero exercise price. This means that the costs of using these interruption contracts for energy balancing do not currently feed through into cash out price calculations. Ofgem considers that this can cause the price signals provided by the cash out arrangements to be reduced. This could weaken incentives on the market to deliver secure supplies. In particular, in instances where demand for gas is high and there is a tight supply/demand balance on the system, and where it is important that balancing costs should be reflected in cash out prices, Transco is actually more likely to use its interruption contracts at a zero exercise price for supply/demand balancing purposes.

Consistent with the views of a number of respondents and Transco NTS, Ofgem considers that restricting or removing the ability for Transco NTS to interrupt for supply/demand purposes would increase confidence in the market and raise expectations that cash out prices will be allowed to rise to a level that enables the market to economically justify projects that stimulate the provision of both supply and demand side services consistent with meeting peak and non peak imbalances.

Ofgem notes the concerns of one respondent in relation to whether the effect of restricting or removing the ability for Transco NTS to interrupt for supply/demand purposes would increase the risk of the market entering a potential gas supply emergency. However, Ofgem agrees with Transco NTS that restricting or removing the ability for Transco NTS to interrupt for supply/demand purposes will ensure that cash out is reflective of the costs of demand reduction, which in turn should further incentivise the market to respond in the appropriate manner to the price signals sent by cash out, reducing the risk of the market entering into an emergency sooner as compared with the current arrangements[9]. Ofgem further considers that it is the primary role of the gas producers, storage operators, shippers and suppliers to ensure that customer demands are met and to secure supplies, not the role of Transco as SO.

Ofgem also notes the concerns of one respondent who considered that it was important to ensure that there is effective and explicit market notification when locational market offers are required by Transco NTS. Transco NTS responded that, should it have a future requirement to take actions in the locational market for supply/demand balancing reasons, it will notify users as soon as such a requirement is identified to allow sufficient time for offers to be placed on the market. Transco NTS stated its intention to notify users of these requirements through the ANS (Active Notification System). In addition this respondent expressed the view that there should be appropriate incentives on Transco NTS to take-up demand-side OCM locational offers. In its capacity as residual energy balancer, in instances where there is an operational balancing requirement, Ofgem would expect Transco NTS to take all physically feasible offers to address this requirement.

Ofgem agrees with the majority of respondents and Transco NTS that there was not a strong case for phasing, i.e. increasing the interruption level in increments over a year as put forward by modification proposal 013. Ofgem agrees with the majority of respondents and Transco NTS that, in terms of timing, it would be more appropriate to introduce the necessary changes in one step, as put forward by modification proposal 013a, since it is important to ensure that any ambiguity in Transco NTS's balancing actions for supply/demand balancing is removed as soon as possible.

Ofgem therefore considers that modification proposal 013a would better facilitate achievement of the relevant code objective (a) for the efficient and economic operation of the pipe-line system as compared to modification proposal 013 and the existing UNC baseline.

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[9] Ofgem notes that on 1 June 2005 Transco NTS submitted Uniform Network Code modification proposal 0021 "Revision of the Emergency Cashout Arrangements". On 1 June 2005, Ofgem granted this modification proposal urgent status.

*Standard Special Condition A 11 (c) securing of effective competition between the relevant shippers and suppliers*

Ofgem is of the view that, under the current arrangements, the existence of the Transco NTS interruptible contracts may reduce the incentives on market participants to develop commercial interruptible services. Ofgem therefore agrees with a number of respondents and with Transco NTS that restricting or removing Transco's right to interrupt for supply/demand management purposes would be likely to encourage competition in the market for commercial interruption services.

The interruption arrangements can potentially distort the efficiency of the gas balancing regime if the costs of interruption for gas balancing purposes are not properly reflected in cash out prices. This may lead to inefficient balancing decisions on the part of shippers and distort competition in the wholesale gas market. Furthermore, it may reduce the extent to which shippers are willing to compete to sell gas to Transco as residual gas balancer.

Ofgem therefore considers that both modification proposals would better facilitate achievement of the relevant code objective (c). However, for the reasons stated above in relation to phasing, Ofgem considers that modification proposal 013a would better facilitate achievement of the relevant code objective (c) for securing of effective competition between the relevant shippers and suppliers as compared to modification proposal 013 and the existing UNC baseline.

*Safety Case*

As Transco NTS's rights to interrupt are included in Transco NTS's Safety Case, Ofgem has consulted the Health and Safety Executive ("HSE")[10] in accordance with its statutory duty requiring consultation regarding all gas safety issues which may be relevant to the carrying out of the Authority's functions under the Act. Although the HSE is not yet in a position to comment upon any possible amendments to Transco NTS's Safety Case, they have received the necessary documentation and are expected to provide a view shortly. Given that the proposed implementation date for this modification is 1 October 2005, Ofgem considers a decision is appropriate on the UNC modification proposal at this time in order to provide sufficient time for industry parties to make the necessary preparations for implementation. Ofgem recognises that the proposed Safety Case changes will be processed in parallel. Should the HSE decline to accept any proposed amendments to Transco NTS's Safety Case it will be open to Transco NTS or any other party so entitled to propose further amendments to the UNC. Ofgem would consider any such proposal on its merits in accordance with normal due process and in particular with regard to best regulatory practice.

*Reform of the interruption regime*

As Transco would no longer be able to interrupt for supply and demand management purposes under the terms of the UNC, Ofgem considers it is appropriate that Transco should consider if pricing of interruption via the OCM and bilateral contracts remains appropriate. Ofgem considers

[10] The HSE is the office of the Health and Safety Commission ("HSC"). The terms 'HSE' and 'HSC' are used interchangeably in this letter.

that this review should form part of the reform of the DN interruption arrangements by April 2006 and as part of the discussions with respect to the enduring offtake arrangements.

**Ofgem's decision**

For the reasons outlined above, Ofgem has decided to direct Transco to implement network code modification proposal 013a because it considers that it better facilitates achievement of the relevant objectives as outlined under Standard Special Condition A11 of the relevant transporter's GT licence and is consistent with the principal objective and statutory duties of the Authority. In particular, Ofgem considers that 013a should better facilitate achievement of the relevant objective set out under Standard Special condition A11 (a) and (c) of the relevant transporter's GT licence – increase the efficient and economic operation by the licensee of its pipeline and securing of effective competition between the relevant shippers and suppliers

If you have any further queries in relation to the issues raised in this letter, please feel free to contact Fiona Lewis on 020 7901 7436.

Yours sincerely

**Sonia Brown**
**Director, Markets**
Signed on behalf of the Authority and authorised for that purpose by the Authority