



Shippers, relevant gas transporters
and other interested parties

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to customers*

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Dear Colleague

Code Modification Proposal 009 “Facilitation of Substitutability between Capacity and Locational Energy Actions” (formerly Transco Network Code modification proposal 0733)

Ofgem¹ has carefully considered the issues raised in modification proposal 009 “Facilitation of Substitutability between Capacity and Locational Energy Actions”.

Having had regard to the principal objective and statutory duties of the Authority², Ofgem has decided to direct the relevant transporters to accept modification proposal 009 because Ofgem considers that the proposal will better facilitate the relevant objectives of the uniform network code (UNC) under Standard Special Condition A11 of the relevant transporters’ gas transporter (GT) Licences.

In this letter, we explain the background to the modification proposal and give reasons for making our decision.

Background to the proposal

Transition from Transco Network Code to UNC

This modification proposal was originally raised by Transco National Transmission System (NTS)³ in accordance with the modification rules set out in Transco’s Network Code⁴. 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 2005, the Modification Panel voted to allow the proposal to

¹ Ofgem is the office of The Gas and Electricity Authority.

² Set out in Section 4AA of the Gas Act 1986, as amended. Ofgem’s statutory duties are wider than the code relevant objectives and include amongst other things a duty to have regard to social and environment guidance provided by the government, to contribute to achievement of sustainable development and to have regard to the principles of best regulatory practice.

³ Where applicable, Transco is referred to as Transco NTS to reflect the relevant entity. However, in some places Transco has been retained to indicate this is the correct term for the reference.

⁴ This modification proposal was previously referred to as modification proposal 0733.

continue through the UNC modification process without re-consultation and modification proposal 009 was assigned its new number.

Transco's NTS System Operator incentives licence changes, April 2004

In Ofgem's conclusions document on the summer supply interruptions⁵ that occurred in June 2003, Ofgem considered that locational gas balancing actions, which are taken on the On-the-day Commodity Market (OCM) to remedy locational network/system constraints, may have a similar impact to buying back entry capacity rights – both function as constraint management tools. Ofgem stated that a constraint could be considered to have occurred where there is a dislocation between the location of supplies entering onto the system and the location of demand for gas from the system.

Under the NTS System Operator (SO) incentive scheme put in place on 01 April 2002, Transco NTS was not incentivised with respect to the use of locational actions to resolve location specific deficits or surpluses. As such Ofgem reviewed this position as part of the consultation process for Transco's NTS SO incentives 2004-07⁶ noting that it is appropriate to include all locational actions, be they sales or buys, so that Transco NTS is incentivised to use the most appropriate tool for resolving locational constraints, both in terms of cost to the community, and in terms of its incentive scheme. Following implementation of the necessary licence modifications to give effect to the substitutability of locational energy and capacity actions in Transco's GT Licence in April 2004, Transco raised modifications to the Network Code, and latterly the UNC to seek to ensure consistency between the provisions of the codes with its Licence.

The modification proposal

Modification proposal 009

Transco NTS's original GT Licence was modified on 1 April 2004 in order to, amongst other things, include the costs and revenues associated with locational actions in Transco NTS's Entry Capacity Buy Back Incentive rather than in its Residual Gas Balancing Incentive. This approach was also applied to all Physical Renomination Incentive (PRI) charges. Transco NTS's GT Licence state that locational actions are "any action taken by [Transco] where the action was taken in respect of a specific location and would therefore be coded with a locational reason code on the OCM." For the avoidance of doubt, not all Transco NTS actions taken on the OCM "Locational" market fall within this definition⁷.

In Ofgem's explanatory notes accompanying the April 2004 GT Licence modifications, Ofgem stated that "...the locational OCM and entry capacity buy backs can both be used with similar purposes in mind." This introduced the concept of substitutability between capacity and locational energy actions.

In order to give effect in the Network Code to the Licence changes, Transco NTS raised modification proposal 0687 "Alignment with Transco Licence Changes Relating to the Treatment of the Costs of Locational Actions in Transco's SO Incentive Schemes" in March 2004. This

⁵ This document can be found at:

http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/4185_Summer_interruptions_conclusions_Aug03.pdf

⁶ The statutory licence consultation for the NTS SO incentives 2004-07 can be found at:

http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/6323_4704.pdf

⁷ In the hypothetical scenario where a national balancing requirement has been identified, and offers on the Locational OCM are the most efficient actions to resolve the requirement, Transco may take Locational actions in preference to higher priced Title and Physical actions. In this scenario, the Locational actions taken will not be identified in the usual manner with the Locational OCM reason code.

modification proposal sought to change the cashflows associated with locational actions (and all PRI charges) so that they feed into Capacity Neutrality rather than Balancing Neutrality. Modification proposal 0687 was directed to be made on 27 August 2004 and implemented on 1 September 2004.

Transco NTS raised modification proposal 009 on 9 December 2004, in order to further align the UNC⁸ with the provisions in the Transco NTS's GT Licence. In its modification proposal, Transco NTS considered that the rationale for raising modification proposal 009 was set out in Ofgem's explanatory notes accompanying the April 2004 GT Licence modifications. Transco NTS focussed on the two scenarios Ofgem outlined to illustrate the potential substitutability between locational energy actions and capacity actions for the purposes of Transportation Constraint resolution. In particular, Ofgem considered the scenario of a supply surplus in one location and a corresponding supply deficit in a different location, which could occur, for example, either side of a Transportation Constraint. Ofgem identified two possible means of resolving this situation. The first approach, using capacity management tools, would be to buy back firm entry capacity to restrict gas flows into the area with the supply surplus, which may in turn redirect gas downstream of the Transportation Constraint, simultaneously resolving the supply deficit. In interpreting this scenario, Transco NTS assumed that scaling any interruptible entry capacity would have taken place prior to the buy back of firm entry capacity. The second approach identified by Ofgem would be to sell gas locationally to limit the gas flows into the area with the supply surplus and then buy gas locationally in the area with the supply deficit.

The UNC allows the use of such mechanisms only in these specified circumstances:

- ◆ Scale back interruptible entry capacity where there is an Entry Capability Shortfall (UNC section B2.9).
- ◆ Buy back firm entry capacity where there is an Entry Capacity Shortfall (UNC section B2.10).
- ◆ Buy gas locationally in order to resolve a Localised Transportation Deficit (UNC section D1.5).

In raising modification proposal 009, Transco NTS stated that it had analysed a number of scenarios and considered that the triggers described above did not allow for full substitutability between locational energy actions and capacity actions. For example it is not possible under the current provisions of the UNC to sell gas at a specific location to resolve a supply surplus at that location. Similarly, it is not possible to take capacity actions at a specific location to resolve a supply deficit elsewhere.

Transco NTS considered, therefore, that the UNC was not consistent with its GT Licence as it did not allow Transco NTS the operational flexibility to choose between capacity and locational energy actions in all circumstances. In order to allow full substitutability as the Licence envisages, Transco NTS believed it is necessary to modify the UNC to amend the triggers for both capacity and locational energy actions, such that Transco NTS would have the ability to:

- ◆ Sell gas locationally upstream of a Transportation Constraint.
- ◆ Scale back interruptible entry capacity where there is no Entry Capability Shortfall.
- ◆ Buy back firm entry capacity where there is no Entry Capacity Shortfall.

⁸ Prior to transference, the modification proposal sought to address an identical perceived defect in the Network Code.

In addition to modifying the UNC to provide what Transco NTS considers are the appropriate triggers, Transco NTS also proposed that modification proposal 009 should revise the treatment of locational actions in the determination of cash out. Currently, when gas has been bought at a location to resolve a Localised Transportation Deficit (see the third trigger above) the following is excluded from cash out determination (UNC section F1.2.4):

- ◆ the locational buy action (Primary Excluded Action⁹); and
- ◆ certain associated locational sell actions (Secondary Excluded Actions) depending on:
 - the volume of the secondary action in relation to the primary action; and
 - the time elapsed between taking the primary and secondary actions.

Under the proposals outlined above, Transco NTS considered that locational sell actions taken as 'primary' actions would also need to be excluded from cash out, as would 'secondary' buy actions. Therefore, Transco NTS believed it was also necessary to modify the UNC to ensure consistent treatment of all locational actions in cash out. This would mean that all actions taken in resolving a Transportation Constraint would be treated as locational actions.

Locational actions taken by Transco NTS are identified by means of reason codes allocated on the OCM at the time of the action being taken. Currently there are several reason codes relating to national and locational actions including those for Primary and Secondary Excluded Actions. In modification proposal 009 Transco NTS stated that it considered that the reason codes should be rationalised, and proposed to retain the following codes only for its actions: NB01 (national buy), NS01 (national sell), LB01 (locational buy) and LS01 (locational sell). Transco NTS proposed that NB01 and NS01 codes would be applied to actions where there was no restriction on where the action could be taken, with these being included in cash out. Conversely, LB01 and LS01 codes would be applied to actions where there was a restriction on the locations where the action could be taken, with these actions being excluded from cash out.

Transco NTS considered that this modification proposal would not require any consequential changes to the Procurement Guidelines, as capacity management is already identified in Table 1 of the Procurement Guidelines as an anticipated application for energy actions. However, Transco NTS stated that changes may be required to the System Management Principles Statement (SMPS) to clarify the underlying principles that Transco NTS would use in determining whether to use a capacity action or a locational energy action.

The following lists identify the tools that would be available to Transco NTS to manage either a locational deficit or a locational surplus should this modification proposal be implemented:

Locational deficit

- ◆ Maximise release of firm entry capacity in the deficit area;
- ◆ Restrict release of firm entry capacity remote from the deficit;
- ◆ Scale back interruptible entry capacity remote from the deficit;
- ◆ Buy back firm entry capacity remote from the deficit; and
- ◆ Buy locally in the deficit area.

⁹ As detailed in section F.1.2.4 of the UNC.

Locational surplus

- ◆ Maximise release of firm entry capacity remote from the surplus;
- ◆ Restrict release of firm entry capacity in the surplus area;
- ◆ Scale back interruptible entry capacity in the surplus area;
- ◆ Buy back firm entry capacity in the surplus area; and
- ◆ Sell locationally in the surplus area.

These lists do not represent the sequence of actions that will be taken by Transco NTS. Indeed, the tools chosen to manage a specific situation may vary depending on its extent and location, the prevailing national balance position and Transco NTS's experience built up over time of the associated costs and relative operational effectiveness of the different tools available.

Transco NTS stated that it intends to propose changes to the SMPS based on the above should this proposal be implemented.

The system changes required to accommodate modification proposal 009 have been considered by Transco NTS and will require a lead time of around one month to implement.

The proposer considers that modification proposal 009 would ensure that the UNC is consistent with Transco NTS's GT Licence by allowing for the substitutability between capacity and locational energy actions. The Proposer further considers that approval of modification proposal 009 would better facilitate the relevant objective identified in Standard Special Condition A11, paragraph 1(c), of the NTS Licence¹⁰, such that Transco NTS will establish transportation arrangements that are consistent with the efficient discharge of the relevant gas transporters' GT Licences, by better aligning the UNC with the provisions of the relevant transporters' GT Licences.

Respondents' views

There were seven responses to modification proposal 009. One respondent supported the modification proposal; four respondents were against the proposal; and two respondents expressed qualified support for the modification proposal.

A number of respondents recognised that it was important to align the UNC with the provisions of Transco NTS's GT Licence. However, one such respondent was concerned about the effect the modification proposal would have on the reporting of cash out prices. This respondent felt that if there was a delay in the publication of prices as a result of the modification, then it should not be implemented.

One respondent considered there is merit in adjusting triggers to give Transco NTS more freedom to resolve constraints, but that the provisions contained within modification proposal 009 would not enable that to occur. This respondent considered it may be difficult for Transco NTS to manage the multiple tools at its disposal in short time periods. Another respondent was of the view that modification proposal 009 may not enable Transco NTS to make efficient decisions when deciding which balancing tool to use as it will not always be clear that one action is more effective than another.

¹⁰ The code relevant objective (c) as defined in Standard Special Condition A11 is as follows:

(c) so far as is consistent with sub-paragraphs (a) and (b), the efficient discharge of the licensee's obligations under this licence.

Several respondents were unclear whether or not adjusting the triggers, as proposed in 009 would necessitate a change to the incentive scheme. One such respondent considered that increased discretion regarding Transco NTS's actions emphasises the importance of the incentive scheme. This respondent considered that there may be occasions where the incentive scheme may not be in line with the most appropriate action.

A number of respondents questioned whether or not locational energy actions are fully substitutable for entry capacity buy back actions. One respondent felt that full theoretical substitutability between locational energy and capacity actions for Transco NTS appears to ignore the impact on the level of full competition in supply of gas through UK entry points. Another respondent stated that it was not convinced that there was full substitutability, rather that there was correlation between the actions.

Several respondents considered that changing the triggers for locational actions, involving capacity scale back or release may extend capacity price risks to shippers competing in the GB market. A further respondent noted that changing Transco NTS's ability to curtail interruptible capacity at entry would undermine shippers' choice of purchasing interruptible capacity, and would thereby change the nature of the capacity product. One respondent noted that increased discretion for Transco NTS's actions may result in the probability of interruptible capacity scale back increasing, and may undermine commercial decisions taken within the entry capacity auctions.

A number of respondents felt that modification proposal 009 confuses the delineation of energy and capacity actions. One such respondent considered that the principle of separating energy and capacity actions appears to have changed to allow Transco NTS the ability to choose actions that are less clearly specified. This respondent considered that if the separation of capacity and energy should be reversed, a clear policy slant should be provided by Ofgem. In addition, this respondent noted that modification proposal 009 would undermine the current targeting of costs of capacity and energy actions by having them separated.

One respondent felt that the proposed mechanism to remove the impact of locational energy actions taken for system reasons from cash out, by simply tagging out locational trades from cash out, was a blunt instrument to address the issue.

Several respondents commented on Transco NTS's use of Ofgem's explanatory notes to the April 2004 GT Licence change as justification for the modification proposal. One respondent felt that this does not appear to be in keeping with due process. A number of respondents made reference to Ofgem's two scenarios from the April 2004 GT Licence modification, as mentioned in the "background to the proposal" section of this letter, one of whom considered that scaling back of firm entry capacity on one side of a constraint to elicit a response on the other side is not guaranteed to work, and is likely to be extremely costly.

Transco NTS's view

Transco NTS considers that there are a number of scenarios in which the current triggers provided in the UNC are at odds with the concept of substitutability of capacity actions and locational energy actions. For example, it is not possible under the UNC to sell gas at a specific location to resolve a supply surplus at that location. Similarly, it is not possible to take capacity actions at a specific location to resolve a supply deficit elsewhere.

Transco NTS considers that the UNC is inconsistent with its NTS Licence as it does not provide the operational flexibility to allow Transco NTS to substitute between capacity actions and locational energy actions in all circumstances.

Transco NTS also notes the importance of considering the treatment of locational actions in the determination of cash out. Modification proposal 009 would amend the current treatment of locational actions in cash out, by excluding locational 'sell' actions taken as 'primary' actions and 'secondary' buy actions. Transco NTS believes it is necessary to modify the UNC to ensure consistent treatment of all locational actions in cash out, such that all actions taken in resolving a Transportation Constraint would be treated as locational actions.

Ofgem's views

Ofgem has carefully considered the views of all respondents and Transco NTS regarding modification proposal 009. In respect of the issues regarding the substitutability between locational energy and capacity actions, Ofgem does not consider that the consultation in relation to modification proposal 009 has raised any issues further than those that had already been considered when it revised Transco NTS's GT Licence to give effect to its proposals for Transco's NTS SO incentive scheme from April 2004. Therefore, having had regard to its principal objective, Ofgem considers that this modification proposal better facilitates the achievement of code relevant objective (c) as set out in paragraph 1 of Standard Special Condition A11 of Transco NTS's GT Licence. Ofgem also considers that this decision is consistent with its wider statutory duties and in particular its duty to further the principles of best regulatory practice by ensuring that the relevant provisions of the UNC provisions and Transco NTS's GT Licence are appropriately consistent.

Relevant objective (c) of the NTS Licence – the efficient discharge of the licensee's obligations under this licence

As detailed in its proposals document in February 2004, Ofgem considers that locational gas balancing actions taken on the OCM to remedy locational network constraints may have a similar impact to buying back entry capacity, as both measures serve as constraint management tools. Due to this substitutability, Ofgem considers that not including locational gas balancing actions within the Entry Capacity Buy Back scheme could allow Transco NTS to use such actions without being required to bear any of the costs. Ofgem considers that this could serve to bias the decision made by Transco NTS when determining which tool to use to resolve a constraint. However, if both constraint management tools are included in the scheme, Ofgem considers that Transco NTS would then face the same proportion of cost and would therefore be able to make an unbiased decision as to which balancing action to take.

Following implementation of modification proposal 0687 on 1 September 2004, the Network Code became better aligned with the provisions of Transco NTS's GT Licence in regard to the conceptual substitutability of locational energy actions and capacity actions. Ofgem considers that modification proposal 009 follows the changes implemented by modification proposal 0687, by further giving effect in the UNC to the changes in Transco NTS's GT Licence implemented by Ofgem as part of Transco NTS's 2004-07 SO incentives. Therefore, Ofgem considers that modification proposal 009 serves to further align the UNC with Transco NTS's GT Licence.

Implementation of modification proposal 009 will make both locational energy actions and capacity actions available for Transco NTS to use in resolving a Transportation Constraint, thus providing Transco NTS with the opportunity, to consider in accordance with its Licence

conditions, which action would be most efficient. This would therefore better facilitate relevant objective 1(c) of Transco NTS's GT Licence.

Having given careful consideration to the views of respondents and Transco NTS, Ofgem does not consider that concerns over the inter-changeability of locational energy and capacity actions potentially having an adverse impact on the effectiveness of the actions that Transco NTS undertakes, will be borne out. Ofgem considers that whilst Transco NTS will have greater discretion regarding the actions it takes to resolve a Transportation Constraint situation, the Licence conditions and NTS SO incentive scheme that Transco NTS is subject to, provide the appropriate framework to ensure Transco NTS takes the most efficient action in a given situation.

In addition Ofgem considers that it is appropriate to enable all actions taken in resolving a Transportation Constraint to be excluded from cash out. Ofgem considers that as locational actions are taken for system reasons such as a constraint, market participants that are in imbalance should not be exposed to the costs that Transco NTS has incurred from system balancing actions. Therefore, where the SO has the ability to explicitly identify a system action such as a locational buy or sell for constraint resolution purposes, it is appropriate for these actions to be removed from the cash out calculation.

Ofgem also notes that the concerns regarding the potential for delayed adjustments to cash out prices as a consequence of modification proposal 009 will not be realised. Currently, where cash out prices are calculated with Secondary Excluded Actions¹¹ in mind, publication of prices may be delayed until such actions and volumes are identified, which Transco NTS notes, is up to hour bar plus two. Code modification proposal 009 will introduce a simpler reason code list to enable more timely identification of excluded actions and therefore faster determination of cash out prices. However, the necessary system changes to accommodate 009 will require a short lead time of approximately one month's duration.

Ofgem also notes respondents' concerns that the revised triggers may have an impact on the nature of the interruptible capacity product. Ofgem considers that by its very nature, an interruptible contract is interruptible, and this modification proposal does not materially affect this situation. Moreover, Ofgem considers modification proposal 009 enables Transco NTS to take a full range of actions to balance the NTS in an efficient manner, consistent with its Licence provisions. If this can be better achieved by making use of the triggers that modification proposal 009 seeks to introduce, it is in the interests of shippers and customers alike.

Ofgem considers that it is beneficial for relevant supporting documentation to be available at the time a modification proposal is consulted upon, enabling the industry to better understand the wider impacts of code modification proposals. In particular, it may have been useful if an assessment of the need for changes to the SMPS had been undertaken concurrent with the development of this modification proposal, albeit that those changes would have been subject to Ofgem's decision on whether to accept this proposal, rather than a direct influence upon it.

Ofgem considers that this decision is in keeping with its statutory duties, and in particular contributes to the furthering of the principles of best regulatory practice by ensuring that the UNC provisions and the relevant transporters' GT Licences are consistent with each other.

The Authority's decision

For the reasons outlined above, the Authority has decided to direct the relevant gas transporters to accept code modification proposal 009 because the Authority considers that it better

¹¹ As detailed in section F.1.2.4 of the UNC.

facilitates the achievement of the relevant objectives as outlined under Standard Special Condition 11, paragraph 1, of Transco NTS's GT Licence and is consistent with the principal objective and statutory duties of the Authority. In particular, the Authority considers that this modification proposal better facilitates the achievement of relevant code objective (c) – the efficient discharge of the licensee's obligations under this licence.

If you have any queries in relation to the issues raised in this letter, please feel free to contact David Hunt on 020 7901 7429.

Yours sincerely

A handwritten signature in black ink, appearing to read "Sonia Brown".

Sonia Brown
Director, Wholesale Markets