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The Joint Office, Relevant Gas
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Dear Colleague

Uniform Network Code modification proposal 0036 “Limitation on incremental capacity offered in QSEC auctions”

On 18 July 2005 Transco National Transmission System (NTS) raised urgent modification proposal 0036 ‘*Limitation on incremental capacity offered in QSEC auctions*’. In July 2005 Ofgem approved a change to the Incremental Entry Capacity Release Methodology Statement (IECR) which provided Transco NTS with a degree of flexibility to specify revised lead times for the delivery of any incremental capacity that is allocated in the long term auctions. Transco NTS has stated that modification proposal 0036 would have the advantage of ensuring consistency between the Uniform Network Code (UNC) and the IECR, as revised.

In the light of concerns raised by respondents regarding the short consultation periods associated with this urgent proposal and on the basis of Ofgem’s recent decision on modification proposal 0030 ‘*Extension of the QSEC auction timetable*’, which extends the time period for undertaking the 2005 Quarterly NTS entry capacity auctions up to 30 November 2005, Ofgem has decided to issue its initial views with respect to this modification proposal and to consult further on a number of key issues related to this proposal.

In addition, a separate letter detailing Ofgem’s initial views on modification proposal 0043 ‘*Limitation on offering for sale unsold capacity*’ and allowing for further consultation, has been issued today.

Background to the proposal

The modifications introduced into Transco's Gas Transporter’s (GT) licence in September 2002 (effective April 2002) introduced the separation of the regulation of Transco's role as Transmission asset owner (TO), where it builds and maintains the network, from its role as National Transmission System (NTS) system operator (SO) where it operates the system on a day-to-day basis and determines the need for additional capacity.

In respect of NTS entry capacity, Transco is funded under its TO function to provide specified TO baseline output measures of entry capacity at each existing entry terminal to its NTS. Under its GT licence, Transco must offer for sale SO baseline output measures, which it does through a series of long-term and shorter-term entry capacity auctions. The SO baseline output measures are set at 90 per cent of the TO baseline output measures at each specified terminal.

Long-term entry capacity auctions

Following Ofgem's approval of modification 0500 to Transco's Network Code, '*Long Term Capacity Allocation*', Transco NTS makes available the SO output measures through auctions of quarterly system entry capacity (QSEC) rights to access the NTS up to 15 years ahead of use. The first long-term auction for the sale of QSEC from 2004 to 2017 was held in January 2003, with subsequent auctions occurring in September 2003 and September 2004 for the periods between April 2005 to March 2020 and April 2006 to March 2021 respectively. In addition, an auction was held in February 2004 for QSEC capacity at two new entry terminals (Garton and Barton Stacey), and an extended auction was held in December 2004 for capacity at Milford Haven. Following Ofgem's approval of modification proposal 0030 '*Extension of the QSEC auction timetable for 2005*' (discussed below) the next long term auctions are scheduled to occur between 1 September and 30 November 2005 for the sale of QSEC rights from April 2007 to March 2022.

Incremental Capacity Release

Under the current entry capacity arrangements, the UNC provides that Transco NTS must auction incremental entry capacity such that, in any year from capacity year +2 to year +16, the 'maximum incremental amount' is not less than 150% of the SO baseline entry volumes that are set out in its NTS GT licence. Whether incremental capacity is allocated in the auctions depends upon the bids received and whether the 'economic tests' set out in the IECR are met.¹

On 25 May 2005 Transco NTS issued an amended version of the IECR for consultation, according to Special Condition C15 of Transco NTS's GT licence, which requires the statement to be reviewed annually. In July 2005 NGT issued a report outlining the main points raised by respondents to the IECR consultation and indicating NGT's final proposals. Among other changes, the final proposals included the provision of a degree of flexibility to specify revised lead times for the delivery of any incremental capacity that is allocated in the long term auctions. The proposed changes were not vetoed by Ofgem.

Modification proposal 0030 'Extension of the QSEC auction timetable for 2005'

Transco NTS submitted non-urgent modification proposal 0030 on 24 June 2005. This modification proposal extends the relevant period for undertaking the 2005 QSEC auction from 1 September 2005 – 30 September 2005 to 1 September 2005 – 30 November 2005, potentially allowing a delay in the commencement of the long term entry capacity auctions.

¹ Principally the Net Present Value (NPV) test.

Ofgem published its decision approving the modification proposal 0030 on 18 August 2005. In addition to providing shippers with the opportunity to consider Ofgem's conclusions on its Unit Cost Allowances consultation², Ofgem noted that, without fettering the discretion of the Authority with respect to its decisions on modification proposals 0036 and 0043, a delay in the auctions would allow the Authority to undertake further consultation on these modification proposals and, following such consultation, for industry participants to consider the implications of the Authority's decision on the proposals.

Modification proposal 0043 'Limitation on offering for sale unsold capacity'

Transco NTS submitted modification proposal 0043 on 9 August 2005 and requested that the proposal be granted urgent status. Ofgem granted the proposal urgent status on 09 August 2005³ and the proposal was issued for consultation on 10 August 2005.

This proposed modification would insert a new paragraph into section B of the UNC to provide, in respect of capacity in to be released in auctions occurring before 31 March 2007, a different regime for unsold NTS entry capacity from that in paragraphs B2.1.5 and B2.1.6 of the UNC. Specifically, it would give Transco NTS the discretion to refuse to make available certain unsold NTS Entry capacity, including baseline and obligated incremental capacity for sale (through the long, short and medium term auctions) at any system entry point in certain circumstances. In particular, the availability of unsold capacity would be excluded:

- ◆ where Transco NTS assesses it may be unable to physically deliver the capacity for any reason, including for example, due to the length of time required to obtain consents or construction challenges; and
- ◆ where Transco NTS assesses there is an expectation that previously allocated capacity at the ASEP would need to be bought back.

It is noted that the proposal would only apply in respect of capacity to be released on any gas day in the period April 2007 to March 2008. Further, Transco NTS has recognised that, in assessing whether to offer unsold capacity for sale, it would still need to ensure that it was able to meet its obligations in Special Condition C8B paragraph 14(5)(f)(ii)(a) of its GT licence.⁴ In addition, Transco NTS stated that it envisaged being required to seek written permission from the Authority before it could refuse to offer unsold capacity for sale.

Transco NTS, in its proposal, indicated that the modification could reduce the exposure of shippers (and therefore customers) to a significant proportion of any entry capacity buy back costs.

² Section 23 notice to modify Transco's Gas Transporter licence, Explanatory note to accompany proposals for new entry points to Transco's National Transmission System, Ofgem, August 2005.

³ Ofgem's decision letter following Transco NTS's request for urgent status can be found on the Gas Transporters Information Service Site (formally known as Nemisys) <https://gtis.gasgovernance.com>

⁴ These obligations require Transco NTS to use all reasonable endeavours to offer for sale baseline capacity and obligated incremental capacity in a clearing allocation.

The Modification Proposal

Against the background set out above, Transco NTS submitted modification proposal 0036 on 13 July 2005 and requested that the proposal be granted urgent status. Ofgem granted the proposal urgent status on 15 July 2005.⁵

In July 2005 Ofgem approved the IECR incorporating a change which provided Transco NTS with a degree of flexibility to specify revised lead times for the delivery of any incremental capacity that is allocated in the long term auctions. Under the revised IECR, where Transco NTS assesses prior to the long term auctions that it may be unable to physically deliver all or part of the incremental capacity within the standard three year investment lead time period at a given entry point, then it may specify a revised lead time (e.g. four years) that is to be applied to the release of part or all of the capacity at that entry point. Under the revised IECR, Transco NTS is required to notify bidders of the amount that could be released within a three year lead time, and also of the earliest practicable date beyond when the remainder would be released. The purpose of this revision to the IECR was to limit the potential exposure to shippers, and therefore customers, of the costs associated with Transco NTS having to buy back capacity that it has allocated in the long term auctions but which it cannot physically deliver within three year investment lead times. This exposure is minimised by providing Transco NTS with greater lead time flexibility.

In summary, the proposal is to amend paragraphs B2.2.3(c)(i) and B2.2.18(d)(v)(1) of the UNC. At present, these provisions require that the "maximum" incremental amount of entry capacity for years + 2 to + 16 should be specified in the invitations for annual NTS capacity auctions at entry points and for NTS capacity auctions at new entry points as:

"being not less than an amount equal to 150% of NTS SO Baseline Entry Capacity".

Under the proposal, for those years, the "maximum incremental amount" specified in the invitations would be amended so that it would be "the lower of" (i) not less than an amount equal to 150% of NTS SO Baseline Entry Capacity and (ii) an amount determined by application of the IECR (as revised).

In making the proposal, Transco NTS stated that the modification would have the advantage of ensuring consistency between the UNC and any relevant provisions of the IECR, in particular the change made in July 2005 allowing Transco NTS to specify a longer lead time than three years where it assesses, prior to the auction invitation, that it "may be unable to physically deliver all or part of anticipated incremental capacity within a three year lead time". As a consequence, if a longer lead time is specified, Transco NTS might not be able to offer as much as 150% of NTS SO Baseline Entry Capacity in certain of the years + 2 to + 16.

Subsequently, Transco NTS has informed Ofgem that it has received a "clear steer" from discussions with shippers, that shippers would value being told in advance of auctions when Transco NTS

⁵ Ofgem's decision letter following Transco NTS's request for urgent status can be found on the Gas Transpoters Information Service Site (formally known as Nemisys) <https://gtis.gasgovernance.com>

thought it would not be able to deliver capacity, rather than having shippers place bids in an auction and Transco NTS deciding ex-post that it would not allocate that level of capacity.

At the same time, Transco NTS has informed Ofgem that, although the existing provisions refer to a "maximum" incremental amount being specified in the auction invitation (which would appear to permit lower amounts to be specified), Transco NTS's interpretation of the provisions is that the reference to this being "not less than" 150% of NTS SO baseline entry capacity entails that, in its view, "150% is a minimum not a maximum".

Respondents' views⁶

Nine responses were received in relation to modification proposal 0036, of which seven were non-confidential responses. Of the seven non-confidential responses, one respondent supported the modification proposal, two respondents offered qualified support and four respondents were not in support. The two confidential responses did not support the proposal.

It is noted that some of the responses offered views on both modification proposal 0036 and modification proposal 0037.⁷

Respondents supporting the proposal

The proposer stated its support for the proposal, but noted that they had no further comments at this stage on the proposal beyond those that were included within the proposal itself.

One of the respondents who offered qualified support noted that its preference would have been to not amend the IECR methodology statement parameters during the price control period and stated they had yet to see a compelling argument in support of the need to change. However, the respondent noted that, given that a change had been made, they supported the principle of pre-auction certainty rather than allowing Transco NTS flexibility after the auctions.

Another respondent accepted Transco NTS's arguments that the current rules may require them to offer capacity at levels which they believe they would be unable to deliver in the timescale associated with the auction. However, the respondent offered only qualified support because of the process that has been followed in raising the proposal. Its preference would have been for the topic to be discussed in the normal industry workstream and, on the assumption that it would have been accepted by the industry, to amend the IECR in line with amendments to the UNC.

⁶ This section is intended to summarise the principal themes of the respondents' views and is not intended to provide a comprehensive overview of the responses received. These can be found on the Gas Transporters information service (formally known as Nemisys)) <https://gtis.gasgovernance.com>

⁷ Modification proposal 0037 '*Limitation on offering for sale unsold capacity*', which was withdrawn 9 August 2005.

Respondents not supporting the proposal

Urgency

One respondent stated that it is unacceptable to raise Urgent proposals with only five days to allow users to respond to proposals where those proposals will have far reaching effects on the LTSEC process by which shippers procure requirements for system entry capacity well into the future. In addition, the respondent stated that the amendment of one of the documents governing the arrangements for system entry capacity does not in itself constitute a reason for urgency in bringing the other elements in line. The respondent commented that this approach exemplifies an abuse of process where a piecemeal approach to implementation of change has been adopted.

Relationship between IECR and UNC consultations

One respondent commented that how any incremental capacity is released post the auctions should be dealt with through Transco's incentives, in connection with the IECR. The respondent also stated that Transco originally sought to place these market rules into these non code documents to avoid the possibility of frequent changes to the arrangements. The respondent stated that Transco NTS should not be able to choose to transfer certain rules back to the code because they feel they are unable to fulfil their contractual obligations to shippers with respect to incremental capacity.

Another respondent believed that the issues set out in the proposal are not matters to be resolved by a UNC modification proposal. In addition, the respondent was disappointed that they had been unable to see the report on the IECR consultation and that there seemed to be no Ofgem letter to accompany its decision not to veto the amendments to the IECR. The respondent also did not agree that there was an inconsistency between the UNC and the IECR (as amended), given that the UNC does not prescribe how Transco NTS decides how to release any incremental capacity above the baseline volume.

One respondent indicated that it was not clear what opinion was given under the consultation process which prompted the changes in the IECR or whether any reasons were given on why Ofgem did not veto the changes. The respondent also considered the UNC to be the appropriate method through which change should be driven rather than the IECR.

Incentives

One respondent stated that the modification proposals cite the commercial exposure directly to the transporter and indirectly to wider industry through neutrality. The respondent commented that, as the exposure to this element of risk is largely within the control of the transporter, it believes that the issue of incentives also needs to be considered in this context. The respondent added that the effect of the modification proposal would be to reduce the risks associated with the inability to deliver obligated capacity. As such, the respondent stated that the degree of Transco NTS's exposure to incentives should reflect this change by increasing share of the related buy back costs.

Another respondent commented that the modification proposal weakens the incentives on Transco NTS in relation to entry capacity buy backs. The respondent stated that changes to incentives

should be addressed through price control review mechanisms rather than code change proposals. The respondent stated that the proposal raises some questions of what has changed to make the three year investment lead time no longer tenable. The respondent considered that the proposal destabilises the relevant objective (a) the efficient and economic investment in the system, through providing a means by which Transco can circumvent its incentives.

A respondent indicated that the provisions of Section C2.3 (e) of the IECR appear to be pre-empting the outcome of auctions themselves by restricting the volume of capacity that is to be offered on sale in the first place. The respondent indicated that further consideration might need to be given to the three year investment lead time. However, it stated that this issue should only be considered as part of the price control process. The respondent also stated that the incentive framework is predicated on the three year investment lead times and that this proposal changes the whole basis of the incentive framework that was agreed at the time of the last price control review. The respondent also did not understand why Transco did not consider bringing forward the date of the auctions to earlier in the year than September.

Another respondent believed that Transco NTS should manage its exposure to buy-backs through the various tools currently at its disposal. The respondent stated that the changes as set out will give Transco NTS the option to avoid such costs by having extended lead times on capacity projects.

Discretion

One respondent recognised that there may be exceptional circumstances where it is not possible, for reasons outside the control of the transporter, for it to deliver incremental capacity within the three year requirement. The respondent commented that in such circumstances it may be appropriate to allow minimum departure from this principle, and stated that the reasons for the variation must be open and transparent, variation must be sanctioned by the regulator, and any resulting restriction in the availability of incremental capacity must be visible to participants in the LTSEC process in advance of it being conducted.

Another respondent commented that the proposal is unclear in the discretion which Transco can use to hold back incremental entry capacity as a result of being unable to make the three year investment lead time.

Panel recommendation

Of the ten voting members of the modification panel one voted in favour of recommending the implementation of this modification proposal. Therefore the panel did not recommend implementation of the proposal.

Ofgem's initial view

Ofgem has carefully considered the views raised by all parties in relation to this proposal. Without fettering the Authority's discretion with respect to the proposal, and having considered the proposal against the relevant objectives of the UNC as well as the Authority's principal objective and statutory duties, our initial view is that the proposal should be approved.

However, taking account of concerns raised through the consultation process, Ofgem also considers that there are some shortcomings with the proposal and the related changes that have been made with respect to the IECR in terms of the degree of discretion that both the proposal and the latest version of the IECR provide to Transco with respect to extending the lead times associated with the provision of incremental entry capacity.

As such, Ofgem's initial view is that there would be merit in proposing modifications to Transco's NTS GT licence, or for Transco NTS to propose modifications to its IECR, to incorporate a formal process through which Transco NTS would require the Authority's consent before it would be able to adjust the lead times for the provision of incremental entry capacity. Ofgem's initial view is that any such consent process would need to be completed prior to the holding of this year's LTSEC auctions.

It is noted that whilst Ofgem is minded to approve this proposal, it would not expect to grant such approval until such time as a formal consent process is established.

The following section outlines the reasons for the initial view that has been reached in terms of the requirements for the UNC in Standard Special Condition A11 of the GT licence.⁸

Standard Special Condition A11(a) – the efficient and economic operation of the pipe-line system to which this licence relates

Ofgem considers that there may be limited circumstances where it is necessary for Transco's NTS business to have the ability to extend investment lead times and therefore lead times for the delivery of incremental capacity, to take account of factors that are beyond its control. In particular, Transco NTS has indicated that the time associated with obtaining planning consents has increased since the long term entry capacity arrangements have been put in place such that, in certain circumstances, it could take Transco NTS four years rather than three years to deliver incremental capacity for reasons it cannot control.

In this context, to require Transco NTS to offer for sale incremental capacity that it cannot deliver for reasons beyond its control would potentially expose shippers and therefore customers to significant buy-back costs through the capacity neutrality mechanism. Ofgem considers that there are likely to be circumstances where this would not be in the interests of customers.

As such, Ofgem considers that there are aspects of this proposal which are likely to better facilitate the efficient and economic operation of the pipe-line system to the extent that it provides Transco NTS with the flexibility to adjust lead times for the delivery of capacity through the IECR and to

⁸ It is noted that Ofgem has also given consideration as to whether it is necessary to modify the relevant paragraphs in the UNC to allow Transco NTS to specify lower capacity levels than 150% of the NTS SO baseline entry capacity, given that the requirement relates to a 'maximum' incremental amount. Ofgem has had regard to Transco NTS's comment (as outlined above) that the 150% level is a minimum, not a maximum. Ofgem considers that the wording of the paragraph may be open to different interpretations and, accordingly, if Transco NTS is to be allowed to specify a lower amount there is merit in clarifying this in the wording of the UNC text.

reflect these adjustments on an ex ante basis through the auction invitation to tender process the rules for which are set out within the UNC.

However, whilst there may be good reasons for granting Transco NTS this flexibility (i.e. to take account of matters beyond its control), this discretion could also be used to delay the delivery of incremental capacity on account of poor planning or project management on the part of Transco NTS. In this case, the granting of a broad discretion may undermine the incentives that have been placed on Transco NTS. In particular, if Transco NTS fails to deliver capacity for reasons that are within its control then it should face exposure under its buy back incentive scheme.⁹

Further, it is also important to note that there are costs associated with any failure on the part of Transco NTS to deliver timely and efficient investment solutions in response to market signals. These costs may manifest themselves in higher auction prices to the extent that demand for entry capacity exceeds what can be physically supplied or higher gas prices to the extent that shippers cannot bring their gas to market.

As a consequence, whilst this proposal gives Transco NTS the discretion to adjust lead times by taking account of factors that are beyond its control or which could not be foreseen, Ofgem considers that it is important that any exercise of this discretion is subject to the Authority's consent to prevent Transco NTS from inappropriately using this discretion to avoid exposure to buy back costs under its incentives.

As such, Ofgem considers that there are improvements that would need to be introduced in advance of this year's long term auctions to ensure that Transco NTS is exercising its discretion to adjust investment lead times in an efficient manner. In particular, Ofgem considers that it would be desirable to introduce a mechanism under which Transco NTS is required to obtain the approval of the Authority before specifying revised lead times under its IECR. Ofgem considers that this may also go some way towards addressing concerns expressed in responses to both this proposal and the IECR consultation regarding how Transco NTS would exercise its discretion.

Ofgem considers that the introduction of a formal consent process should assist in ensuring that the incentive regime was not adjusted in favour of Transco NTS. Ofgem would also note that in any event, Transco's NTS buy back incentive is scheduled for review from April 2007 as part of the forthcoming Transco price control review process and, as such, any concerns regarding the incentive effects of this proposal can be considered in the context of that review.

Ofgem notes that the introduction of such a consent mechanism would necessarily involve it in carefully considering the reasonableness of any Transco NTS proposal and to give weight to factors including Transco NTS performance in managing the delivery of additional capacity, the impacts of any such decision on the efficient and economic operation of the network and competition between shippers.

⁹ It should also be noted that there may be other mechanisms available that could be used to minimise the costs associated with buy backs, other than the provision of discretion and flexibility to Transco NTS. For example, cleared price auctions could be used as a mechanism to allocate any capacity where constraints are expected with any excess revenues being used to offset the costs of capacity buy backs.

Ofgem would welcome views on the introduction of such a mechanism potentially through a modification to the Transco NTS GT licence or through an amendment to Transco NTS's IECR. In either case, Ofgem's initial view is that industry participants would need to be consulted on any application that Transco NTS may wish to make in seeking the Authority's consent to adjust lead times for the delivery of incremental capacity. To the extent that such a consultation occurs, it would be desirable for it to occur such that any approval, if granted, would be given prior to the commencement of the annual long term auctions. Ofgem considers it desirable to introduce this mechanism ahead of this year's annual long term auctions.

Ofgem would therefore welcome views on the timing implications of conducting an approval process prior to the next round of long term entry capacity auctions which are scheduled to be completed prior to 30 November 2005.

Further, in order to assist respondents in commenting upon these options, Ofgem has asked Transco NTS to publish a short document to inform industry participants as soon as possible of the terminal(s) where it may seek to extend investment lead times and to set out the reasons for the delays.

It should be noted that there are regulatory costs associated with introducing such an approval mechanism. As such, Ofgem considers that to the extent such a mechanism is established, it should be on a temporary basis pending a more formal review in the context of the forthcoming NTS price control review process. Such a review could consider whether mechanisms could also be introduced to ensure that any such assessment process (or an alternative process, such as dispute resolution) can occur in a timely manner well before the annual auctions.

Standard Special Condition A11(d) - securing of effective competition between the relevant shippers and suppliers

Ofgem considers that, in the event that Transco NTS wishes to extend the lead times for the delivery of incremental capacity, it is preferable for Transco NTS to notify industry participants of the proposed change in advance of the long term auctions and through the invitation to tender process. Ofgem considers that an advance notification of this nature would assist shippers in preparing efficient capacity booking strategies in ahead of the auctions and should therefore better facilitate the securing of effective competition between shippers.

Process issues

Whilst Ofgem recognises the concerns raised regarding the shortened nature of the consultation periods associated with this proposal, it is important to note that its decision to grant urgency to this proposal was made in the context of an imminent time related event, namely the commencement of the long term auctions. Nevertheless, Ofgem also considers that this proposal could have been raised at an earlier date well in advance of the auctions thereby allowing for longer consultation.

In the light of the concerns raised by respondents regarding the consultation timetable and the Authority's decision on modification proposal 0030, providing for a delay to the start of the

auctions, Ofgem considers that it would be appropriate to provide additional time for participants to comment on this proposal and to comment on Ofgem's initial views.

Views invited

Views are invited in relation to the matters contained in this letter by close of business Wednesday 7 September 2005. Respondents are requested to provide views in a timely manner.

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Electronic responses may be sent to mark.feather@ofgem.gov.uk

Respondents are free to mark their reply as confidential, although we would prefer, as far as possible, open responses that can be placed in the Ofgem library. Ofgem would also prefer that non-confidential responses are sent electronically so that they can be placed on the Ofgem website.

If you wish to discuss any aspect of this letter, Mark Feather (telephone 0207 901 7437) or Matteo Guarnerio (telephone 0207 901 7493) would be pleased to help.

Yours sincerely

Robert Hull
Director, Transmission