



Bringing choice and value
to customers

The Joint Office, Relevant Gas
Transporters and other interested
parties

Our Ref: UNC/Mod/0043
Direct Dial: 020 7901 7050
Email: modifications@ofgem.gov.uk

25 August 2005

Dear Colleague

Uniform Network Code modification proposal 0043 “Limitation on offering for sale unsold capacity”

On 10 July 2005 Transco National Transmission System (NTS) submitted urgent modification proposal 0043 ‘*Limitation on offering for sale unsold capacity*’.

This modification proposal provides Transco NTS with the discretion, in the context of its licence obligations, to refuse to offer baseline and obligated incremental capacity for sale (through the long, short and medium term auctions) at any system entry point under certain circumstances.

The proposal only applies in respect of capacity to be released on any gas day in the period April 2007 to March 2008. In making its proposal, 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 Gas Transporter’s (GT) licence. 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.

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 0036 ‘*Limitation of incremental capacity offered in QSEC auctions*’ and allowing for further consultation, has been issued today.

Background to the proposal

The modifications introduced into Transco'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.

Under the existing entry capacity arrangements, Transco NTS has licence obligations to use all reasonable endeavours to offer for sale baseline capacity and obligated incremental capacity in a clearing allocation¹. These obligations help to ensure that Transco NTS does not withhold capacity from the market for which it has already been provided funding, through its transmission asset owner (TO) price control and SO incentives².

Long-term entry capacity auctions

Following Ofgem's approval of modification 0500 to Transco's Network Code, '*Long Term Capacity Allocation*', Transco 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.

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 Obligated incremental capacity is entry capacity that Transco has taken on an obligation to release at an entry terminal following the satisfaction of the criteria set out in Transco NTS's Incremental Entry Capacity Release Methodology Statement. It is noted that Transco NTS receives SO investment incentive revenues from the sale of obligated incremental entry capacity.

² The 'all reasonable endeavours' obligations are contained in Special Condition C8B (14)(5)(f)(ii)(a) of Transco NTS's GT licence.

Ofgem published its decision letter on modification proposal 0030 on 18 August 2005. In addition to providing shippers with an opportunity to consider its conclusions on Unit Cost Allowances³, 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 0036 'Limitation on offering for sale unsold capacity'

Transco NTS submitted urgent modification proposal 0036 on 18 July 2005. In July 2005 Ofgem approved a change to the Incremental Entry Capacity Release 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.

Ofgem has issued today a letter providing Ofgem's initial views on modification proposal 0036 and allowing for further consultation on the issues raised.

The Modification Proposal

Against the background set out above, 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 2005⁴ 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 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

³ 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.

⁴ 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>

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. 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.

Respondents' views⁵

Eight responses were received in relation to modification proposal 0043. One respondent supported the modification proposal, while seven respondents stated that they were not in favour of the implementation of this modification proposal.

The respondents' views are set out in the section below.

Respondent supporting the proposal

The proposer stated its support for the modification proposal. In its response, the proposer clarified that modification 0043 was proposed as a replacement for modification proposal 0037, which Transco NTS withdrew after careful consideration of the representations received through the consultation process on the proposal. Transco NTS thus proposed modification 0043 limiting the applicability of initial modification 0037 to only certain calendar quarters for which capacity would otherwise be released through capacity auctions conducted during Transco NTS's current price control (prior to 31 March 2007). In addition, the proposer envisaged that it would only be able to not release unsold capacity in accordance with the criteria proposed in the modification with the prior written approval of the Authority. The proposer also considered that modification proposal 0043 prevents releasing unsold capacity in defined exceptional circumstances to avoid exacerbating an existing buy-back requirement at an Aggregate System Entry Point (ASEP) to prevent cost increases for end consumers, until the future entry capacity regime has been further considered and agreed during the next Transmission Price Control Review.

Respondents not supporting the proposal

Licence obligations, Incentives and price control mechanism

One respondent stated that it had some sympathy with the view that Transco NTS should not be obliged to provide capacity above the baseline level where this has not been already allocated within an auction process in accordance with the IECR statement. However, the respondent stated that the proposal also seeks to relieve the transporter of the obligation to make available system entry capacity up to the level of SO baseline. The respondent considered that this was totally unacceptable.

The respondent commented that Transco NTS has licence obligations to make baseline capacity available up to the day-ahead stage, and users will have applied the baseline quantities as being

⁵ 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>

available up to day-ahead in preparing their strategy for longer term acquisition of entry capacity. Finally, the respondent noted that to allow Transco NTS to withhold any element of the baseline capacity suggests that there are amounts within their allowed revenue related to assets that do not exist. The respondent stated that, if this is the case, the transporter should be exposed to a greater proportion of the buyback cost.

Another respondent believed that this modification proposal weakens the fundamental incentives on Transco NTS under which it should bear an appropriate level of risk associated with underperformance including for example buying back capacity rights if investment is not focussed or timely. The respondent noted that incentives and revenues are set relating to the required baseline and incremental outputs and any proposal which impacts these must be dealt through the proper mechanisms of a price control review and not through a code modification.

One respondent stated that Transco NTS accepted a number of complex incentives in its price control, but now appears to be responding to them not by making investment or finding any commercial solutions but by changing the arrangements themselves. The respondent noted that this suggests that the arrangements themselves have not been successful, and reiterated its view that the long term capacity auctions should be subject to independent review. The respondent added that it is likely that Transco NTS is concerned about its own exposure and the effect that this could have on the incentive package, and noted that it may be that Transco NTS has not invested to the extent that it should have to avoid the risk of buyback costs.

Another respondent stated that Transco NTS had made no attempt to quantify the extent of the commercial impact of the buy-back costs mentioned in the proposal, and it has not indicated the volumes of capacity that could be involved. In addition, the respondent noted that the issues of concern to Transco NTS raised by this proposal are not matters to be resolved via a UNC modification proposal and stated that any issues that Transco NTS has with its licence obligations should be addressed via a licence modification / price control negotiations with Ofgem. The respondent noted that, by addressing its concerns with licence obligations via a UNC modification proposal, Transco NTS is attempting to avoid these licence obligations and 'due process'.

The respondent also disagreed with Transco's reasoning that its obligation to release unsold entry capacity should be curtailed in circumstances where it considers there is a significant risk that capacity offered for sale cannot be physically delivered, and believed that such an approach would significantly undermine the existing basis on which capacity is made available, offered and delivered, as well as the incentives regime. The respondent added that if Transco's reasonable assessment is that the risk of buy back costs increasing is so high, then it should seek to renegotiate the buy back element of its incentive scheme with Ofgem. The respondent added that Transco had not provided any information on the impact of the proposal on its ability to recover TO allowed revenue in respect of unsold capacity that comes within the baseline.

Further, this respondent queried the impact that the proposal would have on shippers' abilities to meet customer demand and on their bidding strategies. In particular, the respondent commented that some shippers may have decided not to purchase capacity in the long term auctions in the knowledge that a certain volume of baseline would be released at a later date. The respondent

commented that these shippers would, as a result of this proposal, have the option of securing the capacity in the short term allocations taken away from them.

Another respondent also considered that parties bidding into the entry capacity auctions have made decisions based on the understanding that capacity up to baseline levels would be offered in one or more auctions and that where obligated entry capacity was released then any unsold capacity would also be offered for the appropriate periods in future auctions. In this context the respondent stated that it would be unacceptable for changes to be introduced that would retrospectively affect the value of such capacity. The respondent added that there is a licence obligation that such capacity should be offered in one or more auction and therefore it did not understand how the UNC could be changed unless the licence was also changed.

Another respondent stated that the entry capacity arrangements enabled shippers to choose between a long term product and a short term product making an assessment of the level of competition it was likely to face in each type of auction and their view of risk. This respondent believed that this proposal would undermine the auction process and fundamentally change the nature of the baseline product made available by Transco NTS. The respondent stated that this modification proposal seeks to shift the balance of risk between Transco NTS and shippers without justification and in circumstances where Transco NTS already has a number of mechanisms in place to manage its exposure to baseline capacity provision.

One respondent stated its concern that Transco NTS should provide detailed reasoning with a full cost-benefit analysis of why it believes users may face potentially high buy-back costs.

Timescale

One respondent registered its concerns about the short timescale available to respondents to consider and respond to the proposal.

Another respondent was extremely surprised that the proposal had been raised at all and that it had been afforded urgent status, with less than two and a half days for respondents to comment on the issues. The respondent noted that the consultation timescale was particularly worrying given the significant issues that the proposal raised, and stated that the proposal represented an abuse of the governance process.

Other issues

One respondent stated that it was not clear why if the proposal is only for QSEC auctions conducted prior to 31 March 2007, that the arrangements themselves would need to be changed beyond this date. The respondent therefore stated that it would expect that these changes should go into the transitional arrangements. The respondent also requested clarity on how the process of having written consent from the Authority would work and recommended that if adopted Transco would publicly state that it was doing this before any agreement between Ofgem and Transco was announced.

One respondent stated that restricting access to unsold entry capacity is a barrier to new entrants and therefore detrimental to competition in shipping and supply. The respondent noted that it is not

for the UNC to remove the potential for shippers to obtain unsold capacity solely on the expectation that they will receive buyback payments, and noted that if Transco NTS considers that a party is abusing its position, there are licence and Competition Act provisions to guard against this.

Another respondent expressed their view that the withholding of unsold capacity will create barriers to new entrants into the market as well as to those participants who made the decision to not take part in the long term auctions. In addition, the respondent noted that the suggestion that written permission would be sought from the Authority to not release unsold capacity offers little comfort.

One respondent stated that it recognised Transco's NTS concerns with regard to being required to sell additional capacity when it believes there is a significant risk that it will not be able to deliver the unsold capacity from the capacity allocation date. However, the respondent considered that this risk had been addressed by modification proposal 0036.

Another respondent noted that no detail had been provided of how process of requesting permission from the Authority will be carried out (e.g. timescales). In addition the respondent stated that it was not clear whether a request for permission to withhold unsold capacity is an obligation upon Transco NTS or whether it is optional.

Panel recommendation

At the modification panel meeting of 17 August, of the nine voting members present, 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 principle objective and statutory duties, Ofgem's initial view is that the proposal is finely balanced but should be approved subject to certain amendments to the legal text being made as discussed below.

Taking account of concerns raised through the consultation process, Ofgem also considers that there are some shortcomings with the proposal in terms of the degree of discretion that the proposal provides Transco NTS with respect to limiting the amount of capacity that is made available for sale for the period April 2007 to March 2008. Ofgem notes in this respect that although Transco NTS has stated that it envisaged seeking the written permission of the Authority not to release unsold capacity, this is not stated within the legal text of the proposal.

As such, Ofgem's initial view is that there would be merit in introducing a formal process through which Transco NTS would apply to the Authority for consent to limit the volumes of capacity it may wish to make available for sale for the period April 2007 to March 2008. A formal process of this nature could be established through modifications to Transco NTS's GT licence and potentially through the text of the UNC. 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.

Ofgem notes the views of some respondents that this proposal is seeking to limit the effect of Transco NTS's 'all reasonable endeavours' licence obligation with respect to the release of obligated entry capacity. Ofgem shares these concerns and considers that the legal text of the proposal should make clear that any exercise of discretion on the part of Transco NTS to limit the amount of obligated entry capacity it offers for sale does not in any way limit the operation of the 'all reasonable endeavours' licence obligation. Indeed, Ofgem would not expect to issue any approval to this proposal until the legal text is modified to address these concerns.

Further, it is also noted that whilst Ofgem is minded to approve this proposal, it would not expect to grant such approval until such time as the formal consent process referred to above is established.

The following section outlines the reasons for the initial view that has been reached.

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 limit the amount of unsold obligated entry capacity that it is required to offer for sale, 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 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 ability to limit the amount of unsold obligated entry capacity it is required to offer for sale.

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 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 scheme⁶.

⁶ 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.

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 limit the amount of unsold obligated entry capacity it is required to offer for sale to take 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 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 limiting the amount of unsold obligated entry capacity it offers for sale. Ofgem considers that this may also go some way towards addressing concerns expressed in responses 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.

Ofgem would therefore welcome views on the introduction of such a mechanism through a modification to the Transco NTS GT licence as well as within the legal text of the UNC itself. 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 limit the amount of capacity to be made available for sale. 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 (including this year's 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 limit the amount of unsold obligated entry capacity to be offered for sale and to set out the reasons underlying any such limitation.

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

Ofgem recognises the concerns of respondents regarding the impact of this proposal on competition between shippers. In particular, Ofgem recognises that some shippers may have based their bidding strategies on the understanding that the relevant volumes of obligated entry capacity were to have been offered for sale in accordance with Transco NTS's 'all reasonable endeavours' licence obligations as described above. For Transco NTS to subsequently remove this capacity from the market potentially undermines previous decisions shippers have taken. Indeed, it may distort competition in favour of those shippers which have already been able to secure long term capacity at those terminals where Transco NTS may wish to limit capacity release.

Further, whilst Ofgem cannot fetter the discretion of the Authority, it is mindful of the need to minimise regulatory uncertainty as well as the need to generate confidence that it will not undermine the long term entry capacity regime by fundamentally altering the rules that potentially affect the value of long term entry capacity products.

On this basis, Ofgem is of the view that this proposal is unlikely to have the effect of securing effective competition between shippers and suppliers.

Ofgem would however note that the modification is intended to have limited effect for the period of capacity release from April 2007 to March 2008. As such, any effect on competition will be limited to this period. Further, Ofgem's initial view is that the introduction of a formal process by which Transco NTS is required to obtain the approval of the Authority before limiting any release of obligated capacity should allow the Authority to balance the impacts of any potential buy back costs with the potential impacts of such a limitation on competition.

On this basis, whilst Ofgem's initial view is that the proposal is finely balanced it is nevertheless minded to give its approval once the formal consent process outlined above is established and subject to the amendments to the legal text outlined above regarding the 'all reasonable endeavours' licence obligation.

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 which existed at the time, 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.

However, 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 use this additional time to allow for participants to provide further comments on this proposal and to also 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.

Correspondence should be sent to:

Mark Feather
Associate Director, Networks
Office of Gas and Electricity Markets
9 Millbank
London SW1P 3GE

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