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value to customers*

The Joint Office, Relevant Gas
Transporters and other interested
parties

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Dear Colleague,

Modification proposals 0036 and 0043 - Way forward

On 25 August 2005 Ofgem issued two letters for consultation providing its initial views on Uniform Network Code (UNC) Modification Proposal 0036, '*Limitation on incremental capacity offered in QSEC auctions*' and Modification Proposal 0043, '*Limitation on offering for sale unsold capacity*'. On 26 August 2005, Ofgem issued an addendum to the initial views letter on Modification Proposal 0043.

Following the completion of the consultation on these two letters on 7 September, and having considered the responses that have been submitted, Ofgem is issuing this letter to set out its current views on these proposals and a way forward.

Modification Proposal 0036

Ofgem has carefully considered the submissions of respondents to its initial views consultation on Modification Proposal 0036. A summary of the responses received forms Annex 1 to this letter.

Ofgem's current view

Without fettering the discretion of the Authority with respect to this proposal and having considered the proposal against the relevant objectives of the UNC as well as the Authority's principal objective and statutory duties, Ofgem remains of the view that this proposal should be approved. In this respect, Ofgem notes the views submitted by some respondents that there may be circumstances where it is appropriate for Transco NTS to extend their investment lead times, but only where any such extension is subject to the Authority's approval.

Ofgem therefore also remains of the view that any such approval should not be granted until such time as a formal consent process is established by which Transco NTS, as owner and operator of the National Transmission System (NTS), would be required to obtain the Authority's consent before it is able to adjust the lead times for the provision of incremental capacity in the long term entry capacity allocations.

Establishing a formal consent process

Without fettering the discretion of the Authority, Ofgem considers that it is preferable for any formal consent process to be incorporated within the framework of Transco NTS's Incremental Entry Capacity Release Methodology Statement (IECR). In this respect, Ofgem would note that Transco NTS has indicated that it intends to propose an amendment to the IECR through the process set out in paragraph 5 of Special Condition C15 of its Gas Transporter (GT) licence in respect of its NTS business. Further, Transco NTS has also written to Ofgem seeking the consent of the Authority under Special Condition C15 (5)(iv) to reduce the relevant consultation period from 28 days to 14 days. Ofgem is proposing to grant such a consent.

Ofgem considers it is preferable for the formal consent process to be established through the IECR as opposed to Transco's GT licence as it is the IECR which governs the process by which Transco NTS determines whether to release incremental entry capacity. Ofgem would however note that consideration will need to be given, through the forthcoming transmission price control review process (TPCR), to the nature and timing of any consent process and the governance arrangements surrounding such a process going forward. Further, Ofgem believes consideration should also be given to other alternatives such as dispute resolution as part of the TPCR process and to the relationship of any such process to the timing of the long term auctions.

Ofgem also considers that the IECR modification process is more flexible than the licence modification process and that it is appropriate to use this flexibility in relation to the consultation period on any amendment to the IECR given the proximity of the forthcoming long term auctions.

Consultation on formal consent applications

Ofgem also remains of the view that it is important that Transco NTS undertake a formal consultation process with industry participants on any applications that it may make to adjust investment lead times. In particular, in light of the responses received to the consultation, Ofgem considers that it is important that there is transparency surrounding any consent process such that industry participants are aware, as soon as possible, of which terminals and for what periods Transco NTS would wish to adjust investment lead times. Ofgem considers that such a level of transparency is important so that shippers participating in the long term allocations fully understand the level of capacity that Transco NTS can make available going forward. This should in turn inform bidding in the long term auction process. Ofgem considers that such transparency is particularly important in circumstances where the provider of entry capacity is a natural monopoly with financial incentives to operate and invest in an efficient manner within the context of a traded capacity regime.

In addition, Ofgem considers it is important that shippers and other industry participants should be able to provide input into any consultation that Transco NTS may undertake, for example, by commenting on various elements of the planning process, including the obtaining of relevant planning consents.

Ofgem does not accept the concerns raised by Transco NTS regarding the impact on possible buy back costs of releasing information on investment lead times at particular entry points. Ofgem considers that there are sufficient protections within the regulatory framework to ensure that customers may be protected from unacceptable or anti-competitive shipper behaviour in the

buy back market through the provisions of the Gas Shipper licence and the Competition Act 1998.

In this respect Ofgem notes the provisions of Standard Condition 3(2) of the Gas Shipper licence which requires that the licensee shall not knowingly or recklessly pursue any course of conduct that is likely to prejudice:

- (a) the safe and efficient operation, from day to day, by a relevant transporter of its pipeline system;
- (b) the efficient balancing by the transporter of its system; or
- (c) the due functioning of the arrangements provided for in its network code.

Ofgem would also refer in this context to the guidance it has previously provided to shippers in respect of conduct in the capacity market.¹

Timetable

Ofgem recognises that there is only a short period of time available for such a consent process to be established and for any consents requested by Transco NTS to be assessed in advance of a November 2005 long term auction.

In order to address these competing factors, Ofgem has agreed an indicative timetable with Transco NTS which forms Annex 2 to this letter. This indicative timetable is based around ensuring that the next long term entry capacity allocations can be completed by 30 November 2005 with the final date for the issue of any invitation to tender being 19 October 2005.

It is noted that Ofgem does not intend to issue its final decision letter on this proposal until such time as the formal consent process outlined above is in place.

Modification proposal 0043

Ofgem has carefully considered the submissions of respondents to its initial views consultation on modification proposal 0043. A summary of the responses received forms Annex 1 to this letter.

Ofgem's current view

Without fettering the discretion of the Authority with respect to this proposal and having considered the proposal against the relevant objectives of the UNC as well as the Authority's principal objective and statutory duties, Ofgem remains of the view that this proposal should be approved. However, Ofgem also remains of the view that any such approval should not be granted until such time as a formal consent process is established by which Transco NTS, as owner and operator of the National Transmission System (NTS), would be required to obtain the Authority's consent before it is able to limit the volumes of entry capacity made available in the long term entry capacity allocations.

¹ See 'Ofgem's investigation into shipper conduct in the capacity market in October 2000', Conclusions, Ofgem, November 2001.

Ofgem notes the concerns that have been raised by respondents regarding the interaction between this modification proposal and Transco NTS's licence obligations as set out in Special Condition C8B (14)(5)(f)(ii)(a) of its GT licence. With a view to clarifying this interaction, Ofgem notes the following.

Firstly, Ofgem is of the view that the terms and conditions of the UNC can not fetter the Authority with respect to the enforcement of Transco NTS's licence obligations in Special Condition C8B (14)(5)(f)(ii)(a), or indeed any other licence obligation. Transco NTS's licence obligations exist independently of the provisions of the UNC, and the UNC can not be relied upon to interpret compliance or otherwise with Transco NTS's licence obligations. Ofgem is therefore of the view that it is not appropriate for Transco NTS's licence obligations to be referenced in the UNC in these circumstances.

Secondly, Ofgem is of the view that in the event that this modification proposal is implemented, the most appropriate way to clarify how the licence obligations in Special Condition C8B (14)(5)(f)(ii)(a) will operate in the circumstance that the Authority decides to approve an application for consent to withhold unsold NTS entry capacity for sale under the UNC is within the text of Special Condition C8B. Therefore, in the event that this modification proposal is implemented, Ofgem would amend Special Condition C8B (14)(5)(f)(ii)(a) to provide that the licensee must comply with the obligations stated within Special Condition C8B (14)(5)(f)(ii)(a) except where the Authority otherwise consents. As a result, there will be parallel consent processes under the UNC and the relevant licence condition.

Ofgem would emphasise that this proposed approach is aimed at preserving the licence obligations within Special Condition C8B (14)(5)(f)(ii)(a) in the generality of cases, whilst providing clarity that the obligations should not, as a matter of practicality, apply to Transco NTS offering for sale unsold NTS entry capacity at a specified date where the Authority has consented to Transco NTS not doing so under the UNC.

Interaction with incentives and price controls

Ofgem notes the concerns that respondents have raised regarding Transco NTS seeking to limit the volumes of system operator (SO) baseline capacity to be made available for sale and the concerns that this may undermine the incentives and price control framework set for the present price control period.

Ofgem recognises these concerns and is of the view that Transco NTS would only be permitted to limit either baseline or obligated incremental capacity for sale by exception, where there is a strong and robust justification for doing so. In particular, Ofgem would need to be satisfied that the reasons for Transco NTS's inability to provide the capacity were related to factors beyond its control. In this context, Ofgem would also need to consider Transco NTS's own performance in managing the delivery of the capacity in particular in relation to its obligations with respect to the economic and efficient operation of its system.

Further, Ofgem would need to have regard to the potential costs that shippers (and potentially customers) may be exposed to through capacity neutrality in the event of any buy backs of that capacity were it to be offered for sale and sold. In addition, and as noted in the 'minded to' letter, Ofgem would need to have regard to the impact on competition between shippers of any decision to limit the amount of capacity to be made available for sale.

Establishing a formal consent process

Ofgem considers that it is preferable for any formal consent process to be incorporated within the framework of the UNC. Indeed, Ofgem considers that it should be possible to amend the legal text of this proposal to include a requirement for Transco NTS to obtain the consent of the Authority before limiting capacity availability. Ofgem notes in this respect that modification proposal 0043 already envisages that Transco NTS would seek the approval of the Authority to not release unsold capacity. On this basis, Ofgem intends to write to Transco NTS requesting that the legal text of the proposal be amended to reflect this requirement.

Consultation on formal consent applications

In light of the responses received to the 'initial views' consultation on the issue of transparency, Ofgem also remains of the view that it is important that Transco NTS undertake a formal consultation process with industry participants on any applications that it may make to limit the amount of capacity to be offered for sale. Ofgem considers that the reasons underlying the need for a formal consultation are the same as those discussed earlier with respect to modification proposal 0036 and hence they are not repeated here.

Timetable

Ofgem recognises that there is only a short period of time available for such a consent process to be established and for any consents requested by Transco NTS to be assessed in advance of a November 2005 long term auction.

In order to address these competing factors Ofgem has agreed an indicative timetable with Transco NTS which forms Annex 2 to this letter. This indicative timetable is based around ensuring that the next long term entry capacity allocations can be completed by 30 November 2005 with the final date for the issue of any invitation to tender being 19 October 2005.

As with modification proposal 0036, Ofgem does not intend to issue its final decision letter on modification proposal 0043 until the necessary amendments have been made to the legal text of modification 0043 as discussed above. In Ofgem's view, the proposed licence modification is one of clarification with respect to Special Condition C8B (14)(5)(f)(ii)(a) and therefore its implementation need not delay the Authority's consideration of Modification Proposal 0043.

If you wish to discuss any aspect of this letter, Suzanne Turner (telephone 0207 901 7338) would be pleased to assist.

Yours sincerely

Robert Hull
Director, Transmission

ANNEX 1

SUMMARY OF RESPONDENTS' VIEWS²

List of respondents

1. The proposer - Transco NTS
2. British Gas Trading Limited
3. RWE npower
4. Scottish and Southern Energy plc
5. Shell Gas Direct Limited
6. Statoil UK Limited
7. Total Gas & Power Limited
8. Wales and West Utilities Limited

Modification Proposal 0036

Of the seven respondents (excluding the proposer – Transco NTS), only five provided comments on whether they supported Modification Proposal 0036 specifically.

One respondent stated that they remained opposed to this proposal and did not support its implementation as it would not better facilitate the relevant objectives.

Three respondents offered qualified support for the modification proposal. This respondent stated that they did not find sufficient comfort in the drafting of the detail of the proposal to lend their unreserved support. Another respondent noted that they would have preferred Transco not to have amended the IECR methodology statement parameters during the current price control period.

Finally, one respondent stated that it is not possible to come to a definitive view on this modification proposal whilst it is at an early stage of development.

² This Annex 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 Ofgem website: http://www.ofgem.gov.uk/ofgem/work/index.jsp?section=/areasofwork/gasgovernance&levelids=,1_11456#top11456.

Modification Proposal 0043

Of the seven respondents (excluding the proposer – Transco NTS), six expressed opposition to Modification Proposal 0043.

Two respondents stated that they did not believe the proposal better facilitated the relevant objectives, with one stating the potential impact upon competition. Another stated that they remained of the opinion that this modification should not be implemented as it will have a negative impact on the auction process and shippers who have made decisions based around the existing mechanisms and baselines. Another respondent stated that introducing a formal approval process would not change its view.

One respondent stated that it is not possible to come to a definitive view on this modification proposal whilst it is at an early stage of development.

Information available to assess modification proposals

A number of respondents stated that they did not have sufficient information to be able to assess the modification proposals. Many noted that Transco NTS had failed to provide any indication of the materiality of its proposal, either in terms of the volumes of capacity that could be involved or the number of entry points affected.

Time available to assess modification proposals

A number of respondents commented on the timescales within which the modification proposals were being considered.

The proposer stated that the 2005 QSEC auction should be completed by 30th November 2005 to avoid creation of further uncertainty within the industry regarding their long term capacity positions and further modifications to amend the UNC to reflect any later auction completion dates.

However, a number of respondents requested more time to consider the proposals or asked why such proposals had not been raised earlier. One respondent stated that the relevant workstream should be afforded a realistic period of time to examine the possibilities and deliver a robust mechanism and hence that the proposal should be sent back to the workstream with a target delivery date of 2006, prior to the commencement of the subsequent LTSEC auctions.

Consistency of modification proposals with price control settlement

A number of respondents raised concerns regarding the modification proposals, their consistency with Transco NTS's existing price control settlement, and the implications for the risks faced by shippers and customers.

A number of respondents were particularly concerned regarding the possibility that Transco NTS may not make available all of its baseline capacity and argued that this would undermine the basis of Transco NTS's price control and the incentive regime which they are subject to and had accepted. One respondent stated that there should be a commensurate change to the incentives or price controlled allowed revenues, and another respondent stated that Transco NTS should be exposed to a greater proportion of the buyback cost within their incentive arrangements.

A number of respondents stated their view that by reducing risks to Transco NTS, there would be a consequential increase in the risks faced by shippers, and hence customers. One respondent argued that the proposed approach would distort the existing price control and incentives framework, and result in a further "churn" of costs which would be recovered only from shippers and ultimately passed on to customers.

Two respondents also noted the potential for an adverse impact upon security of supply, with one respondent stating that there was a risk that gas would be stranded in storage facilities where typically parties buy entry capacity on a seasonal and short-term basis.

Authority approval process

In general, those respondents that expressed an opinion, expressed qualified support for the proposed Authority consent processes associated with both modification proposals, should they proceed.

The proposer recognised Ofgem's concerns regarding the degree of discretion that both proposals and the latest version of the IECR provided with respect to extending the lead times for provision of incremental and unsold capacity and stated that they supported the introduction of a formal mechanism through which they would be required to obtain approval from the Authority.

Incorporation of the Authority consent process with respect to Modification Proposal 0036

A number of respondents commented on the way in which the Authority consent process should be introduced with respect to Modification Proposal 0036.

Both the proposer and another respondent stated that the IECR methodology statement should be amended to include Authority consent provisions.

Two respondents questioned why the consent process could not be incorporated into the UNC and stated that this would be the first best solution, although one stated that their priority was to ensure a minimum of delay to the auction process.

Another respondent stated that, in the event that this process is no longer required and Transco NTS is in a position to honour the volumes and lead times envisaged in the Licence, the IECR is immediately modified and the consent process is removed.

Incorporation of the Authority consent process with respect to Modification Proposal 0043

The proposer noted Ofgem's suggestion to amend the legal text for this proposal. Firstly, to include clarification that Transco NTS is required to obtain written permission to not release capacity, which the proposer stated was appropriate and could be undertaken without further UNC Modification Proposals.

Secondly, to include clarification within the legal text that any exercise of discretion does not limit the operation of the "reasonable endeavours" obligation within Special Condition C8B paragraph 14(5)(f)(ii)(a) of Transco NTS's GT Licence. However, the proposer stated that this could not be satisfied by a change to the existing legal text because the Authority is not a party to the UNC and therefore could not enforce the provision. However, the proposer stated that, at the time of submission, the Authority can consider and either accept or reject the request with consideration to the "reasonable endeavours" obligation. Finally, the proposer stated that the "reasonable endeavours" obligation still applies even if it is not specifically stated in the UNC.

One respondent stated that they were unclear how a provision in the UNC could potentially "over-ride" an existing licence obligation. This respondent also stated that there should be safeguards in the proposed UNC legal text to limit Transco NTS discretion. Another respondent endorsed Ofgem's view that the Transporters must be bound by their "all reasonable endeavours" licence obligations.

Interaction between Authority approval and the auctions

A number of respondents stated that any restrictions in the availability of capacity should be visible to participants in advance of the auctions taking place in order to maintain an open and transparent process.

Consultation on individual Transco NTS applications

A number of respondents provided comments on whether any future applications by Transco NTS for Authority consent should include an industry-wide consultation.

The proposer stated that they were opposed to such consultations because:

- ◆ if the request is not granted, the release of information may increase demand for the capacity at that terminal and exacerbate the level of resulting buy-back costs which the application was trying to address;
- ◆ it is considered that users would not be in a position to comment on whether proposed delays are appropriate;
- ◆ industry-wide consultation is likely to delay the process; and
- ◆ it could prejudice the planning consents process.

Another respondent agreed with the proposer's position, stating that industry participants would not necessarily have sufficient knowledge to respond to such a consultation and that, as such, it could only unduly influence the auction process.

One respondent stated that interested parties should have the opportunity to comment on the criteria and rationale that would drive an application for consent by Transco NTS or that such criteria should be incorporated into the UNC legal drafting. Another respondent noted that additional consultation by Ofgem would only add to the level of administrative and regulatory activities relating to the LT auction processes.

However, two respondents were in favour of industry-wide consultation. One respondent stated that any concerns Transco have about the commercial implications of releasing this information should encourage them to only exercise this option where there are transparent and unambiguous consenting hurdles facing a particular investment project. This respondent further

stated that any concerns about shippers using this information to game the capacity buy back regime are unfounded due to shipper licence obligations and Competition Act provisions.

ANNEX 2

ENTRY CAPACITY

ADJUSTMENTS TO LEAD TIMES AND LIMITATIONS ON CAPACITY RELEASE

INDICATIVE TIMELINE

Date	Deliverable
Wednesday 7 September	Consultation on minded to letters (0036 and 0043) closes.
WEEK COMMENCING 12 SEPTEMBER	
Tuesday 13 September	<p>Ofgem issues letter outlining way forward in light of responses to 'minded to' consultation.</p> <p>Transco NTS writes to Joint Office seeking amendments to legal text for Modification proposal 0043.</p> <p>Ofgem consents to shortened consultation on revisions to IECR of 14 days.</p>
Wednesday 14 September	<p>Transco NTS initiates consultation to amend IECR to incorporate a formal approval process under Special Condition C15(5).</p> <p>Final Modification Report reissued to Ofgem on Modification Proposal 0043 including requirement on Transco NTS to obtain Authority consent in writing before limiting capacity to be made available for sale.</p> <p>Ofgem initiates formal consultation under Section 23 of the Gas Act proposing modifications to modify Special Condition C8B (14)(5)(f)(ii)(a).</p>
WEEK COMMENCING 19 SEPTEMBER	
Wednesday 21 September	Transco NTS initiates consultation to adjust investment lead times and to limit volumes of capacity to be made available for sale at relevant terminal(s). Consultation period progresses for 2 weeks.

	IECR consultation continues.
WEEK COMMENCING 26 SEPTEMBER	
Wednesday 28 September	IECR consultation closes.
Friday 30 September	Transco NTS provides report to Authority on IECR changes.

WEEK COMMENCING 3 OCTOBER	
Tuesday 4 October	Ofgem issues decision letter on revised IECR and final decision letters on modification proposals 0036 and 0043.
Wednesday 5 October	Consultation on Transco NTS consent applications ends.
Friday 7 October	Transco NTS delivers formal submission and report to Authority requesting consents to revise lead times under IECR and limit volumes of capacity to be made available for sale at relevant terminal(s).

WEEK COMMENCING 10 OCTOBER	
Wednesday 12 October	Section 23 consultation ends on licence modifications.
Friday 14 October	Ofgem issues decision on licence modifications.

WEEK COMMENCING 17 OCTOBER	
Monday 17 October	Transco NTS makes application for consent to limit volumes of capacity to be made available for sale at relevant terminal(s) under Special Condition C8B (14)(5)(f)(ii)(a).
Tuesday 18 October	Ofgem issues decision on Transco NTS applications to revise lead times under IECR and limit volumes of capacity to be made available for sale at relevant terminal(s).
Wednesday 19 October	Last date for Transco to issue ITT for November auction given 24 day notice period and 10 day auction.