

**To: The Company Secretary  
National Grid Gas plc  
1-3 Strand  
London WC2N 5EH**

**DIRECTION UNDER SECTION 23(3) OF THE GAS ACT 1986 IN RELATION  
TO NATIONAL GRID GAS PLC'S GAS TRANSPORTER LICENCE IN RESPECT  
OF ITS NATIONAL TRANSMISSION SYSTEM**

Whereas –

1. National Grid Gas plc, previously named Transco plc, (“the Licensee”) is the holder of a gas transporter (GT) licence in respect of its National Transmission System (NTS) (“the Licence”) treated as granted under section 7 of the Gas Act 1986 (the Act).
2. Pursuant to section 23(3) of the Act, the Gas and Electricity Markets Authority (“the Authority”) gave notice on 14 September 2005<sup>1</sup> (“the Notice”) that it proposed to modify Special Condition C8B(14)(5)(f)(ii)(a) of the Licence by:
  - (a) inserting the words “except where, and to the extent that, the Authority has otherwise consented in writing.” after the words “at the end of day of month m”; and
  - (b) deleting “for” and inserting “For” such that the phrase “for the avoidance of doubt” is the start of a new sentence.
3. Prior to the close of the consultation period in respect of the Notice, the Authority received two responses in relation to the proposed modification of Special Condition C8B(14)(5)(f)(ii)(a) of the Licence. No responses were withdrawn. All non-confidential responses are available from the Ofgem Research and Information Centre and on the Ofgem website<sup>2</sup>.
4. The Authority has carefully considered all representations made in relation to the proposed modification of Special Condition C8B(14)(5)(f)(ii)(a) of the Licence and not withdrawn.

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<sup>1</sup> 202/05 - Notice under section 23(3) of the Gas Act 1986 - Modification proposed to the gas transporter licence held by Transco plc in respect of the NTS.

<sup>2</sup> <http://www.ofgem.gov.uk/ofgem/work/index.jsp?section=/areasofwork/gasgovernance>, linked to document 202/05.

5. Pursuant to section 23(4)(b) of the Act, the Authority gave notice of its intention to modify Special Condition C8B(14)(5)(f)(ii)(a) of the Licence to the Secretary of State and has not received a direction from the Secretary of State not to make the modification.
6. On 30 September 2005 the Licensee gave its written consent to the proposed modification of Special Condition C8B(14)(5)(f)(ii)(a) of the Licence.
7. Pursuant to section 38A of the Act, the Authority's reasons for making this direction to modify Special Condition C8B(14)(5)(f)(ii)(a) of the Licence are set out in Appendix 1 to this document.

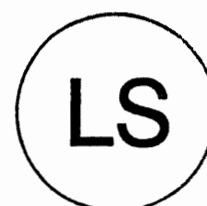
Pursuant to the powers contained in section 23 of the Act, the Authority hereby directs that Special Condition C8B(14)(5)(f)(ii)(a) of the Licence is modified as follows with effect on and from 17 October 2005:

- (a) inserting the words "except where, and to the extent that, the Authority has otherwise consented in writing." after the words "at the end of day d of month m"; and
- (b) deleting "for" and inserting "For" such that the phrase "for the avoidance of doubt" is the start of a new sentence.

The official seal of the Gas and Electricity Markets Authority is affixed to this Direction and is authenticated by



**Robert Hull**  
**Director, Transmission**



**Duly authorised on behalf of the Authority**

**17 October 2005**

## Appendix 1: Reasons for the Licence Modifications

### Modification Proposal 0043

1. On 10 August 2005, Transco NTS (now National Grid NTS and hereafter referred to as such) submitted Modification Proposal 0043 under the Uniform Network Code ("UNC"). This modification proposal provides National Grid NTS with the discretion not to offer baseline and obligated incremental capacity for sale (through the long, short and medium term auctions) at any system entry point in the following circumstances:
  - (a) where National Grid 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
  - (b) where National Grid NTS assesses there is an expectation that previously allocated capacity at the ASEP would need to be bought back.
2. In Modification Proposal 0043, National Grid NTS stated that, in making its assessment as to whether to release unsold capacity in any auction, it would still need to ensure that it was able to meet its obligation under Special Condition C8B Part 2 paragraph 14(5)(f)(ii)(a) of its Licence to "use all reasonable endeavours to offer for sale" all obligated entry capacity<sup>3</sup>. National Grid NTS therefore believed that the criteria proposed to be included within the UNC when considered in combination with its Licence obligations would result in unsold capacity not being released through auctions conducted in this formula period only in exceptional circumstances.
3. In its proposal, National Grid NTS envisaged that it would be required to seek written permission from the Authority to not release unsold capacity and considered that this should mitigate industry concerns regarding the amount of discretion that National Grid NTS may be perceived to be granted in not releasing unsold capacity, were Modification Proposal 0043 to be implemented.

### Ofgem Initial Views Letter

4. On 25 August 2005 Ofgem issued a letter for consultation providing its initial views on Modification Proposal 0043 (the "**Initial Views Letter**"). On 26 August 2005, Ofgem issued an addendum to the Initial Views Letter.
5. In the Initial Views Letter Ofgem expressed concern regarding the degree of flexibility that the proposal could afford to National Grid NTS and stated its view that there would be merit in introducing formal Authority consent processes such that Authority consent is required for National Grid NTS to use its discretion to withhold capacity for sale.
6. In the Initial Views Letter Ofgem stated that it had carefully considered the views raised by all parties in relation to this proposal and that without fettering the Authority's discretion with respect to the proposal, and having considered

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<sup>3</sup> National Grid Gas plc holds a licence in respect of its National Transmission System, however, for brevity, National Grid NTS (the Transmission division within National Grid Gas plc) is referred to as if it were the licensee throughout this Appendix.

the proposal against the relevant objectives of the UNC as well as the Authority's principal objective and statutory duties, Ofgem's initial view was that Modification Proposal 0043 was finely balanced but should be approved subject to certain amendments to the legal text.

7. Taking account of concerns raised through the consultation process, Ofgem stated that it considered that there were some shortcomings with the proposal in terms of the degree of discretion that the proposal provided National Grid NTS, with respect to limiting the amount of capacity that is made available for sale. Ofgem noted in this respect that although National Grid NTS had stated that it envisaged seeking the written permission of the Authority not to release unsold capacity, this was not stated within the legal text of the proposal.
8. As such, Ofgem's initial view was that there would be merit in introducing a formal process through which National Grid NTS would apply to the Authority for consent to limit the volumes of capacity it may wish to make available for sale. Ofgem noted that a formal process of this nature could be established through modifications to National Grid NTS's GT licence and potentially through the text of the UNC. Ofgem's initial view was that any such consent process would need to be completed prior to the holding of this year's Long Term System Entry Capacity (LTSEC) auctions.
9. Ofgem noted the views of some respondents that this proposal was seeking to limit the effect of National Grid NTS's "all reasonable endeavours" licence obligation with respect to the release of obligated entry capacity. Ofgem stated that it shared these concerns and considered that the legal text of the proposal should make clear that any exercise of discretion on the part of National Grid 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 stated that it would not expect to issue any approval to this proposal until the legal text was modified to address these concerns. Ofgem further noted that it would not expect to grant such approval until such time as the formal consent process referred to above was established.

#### **Responses to Initial Views Letter on Modification proposal 0043**

10. In response to the Initial Views Letter National Grid NTS noted Ofgem's suggestion to amend the legal text for this proposal in two areas:
  - (a) to include clarification that National Grid NTS is required to obtain written permission to not release capacity: National Grid NTS stated that this was appropriate and could be undertaken without further UNC Modification Proposals; and
  - (b) to include clarification within the legal text that any exercise of discretion does not limit the operation of the "all reasonable endeavours" obligation within Special Condition C8B paragraph 14(5)(f)(ii)(a) of National Grid NTS's GT Licence: National Grid NTS stated that they did not consider that this can 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, National Grid NTS stated that this requirement can be satisfied by the formal mechanism of applying to the Authority to withhold capacity from sale

and at the time of submission the Authority can consider and either accept or reject the request with consideration to the “all reasonable endeavours” obligation. In any event, National Grid NTS stated that the “all reasonable endeavours” obligation still applies even if it is not specifically stated in the UNC.

### **Ofgem Way Forward Letter**

11. Following the completion of the consultation with respect to the Initial Views Letters on 7 September, and having considered the responses that had been submitted, Ofgem issued an open letter setting out its current views on the proposal and a way forward (the “**Way Forward Letter**”).
12. In the Way Forward Letter, Ofgem stated, in respect of Modification Proposal 0043 that, 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, it remained of the view that Modification Proposal 0043 should be approved. However, Ofgem also stated that it remained of the view that any such approval should not be granted until such time as a formal consent process is established by which National Grid Gas, as owner and operator of the 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.
13. In the Way Forward Letter, Ofgem noted the concerns that had been raised by respondents regarding the interaction between Modification Proposal 0043 and National Grid NTS’s licence obligations as set out in Special Condition C8B(14)(5)(f)(ii)(a) of the Licence. With a view to clarifying this interaction, Ofgem noted the following:
  - (a) Firstly, that Ofgem was of the view that the terms and conditions of the UNC can not fetter the Authority with respect to the enforcement of National Grid NTS’s licence obligations in Special Condition C8B(14)(5)(f)(ii)(a), or indeed any other licence obligation - National Grid 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 National Grid NTS’s licence obligations. Ofgem stated that it was therefore of the view that it would not be appropriate for National Grid NTS’s licence obligations to be referenced in the UNC in these circumstances; and
  - (b) Secondly, that Ofgem was of the view that, in the event that Modification Proposal 0043 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 Modification Proposal 0043 is implemented, Ofgem stated that it 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, Ofgem noted that there would be parallel consent processes under the UNC and the relevant licence condition.

### **The Section 23 Notice**

14. Further to, and for the reasons set out in the Way Forward letter, on 14 September 2005, the Authority gave notice pursuant to section 23(3) of the Gas Act 1986 of its proposal to modify Special Condition C8B(14)(5)(f)(ii)(a) of National Grid NTS's licence by:
  - (a) inserting the words "except where, and to the extent that, the Authority has otherwise consented in writing." after the words "at the end of day d of month m"; and
  - (b) deleting "for" and inserting "For" such that the phrase "for the avoidance of doubt" is the start of a new sentence.
15. The licence modifications proposed in this notice were intended to allow the Authority to provide explicit clarification of the applicability of the licensee's obligation to use all reasonable endeavours to offer for sale obligated entry capacity under Special Condition C8B(14)(5)(f)(ii)(a) of the Licence in the circumstances that consent to withhold capacity for sale is granted under the UNC pursuant to Modification Proposal 0043, should it proceed.
16. In proposing these licence modifications, it was Ofgem's aim to preserve the obligation under Special Condition C8B(14)(5)(f)(ii)(a) of the Licence in the generality of cases, whilst providing clarity that there may be very specific circumstances under which it may not be appropriate for the licence obligation to apply. That is, where the Authority has consented under the UNC to the licensee not offering particular obligated entry capacity for sale during a particular period.
17. The notice stated that any consent which may be granted by the Authority under the modified provisions of Special Condition C8B(14)(5)(f)(ii)(a) of the Licence would be very specific with regards to the capacity, period and circumstances to which it applies. The licensee's obligation to use all reasonable endeavours to offer obligated entry capacity for sale will continue to apply in all other circumstances that do not fall within the very specific terms of the consent.
18. As the proposed licence modifications are linked to the implementation of Modification Proposal 0043, the Authority only proposed to direct these licence modifications if Modification Proposal 0043 was implemented.

### **Modification Proposal 0043**

19. On 4 October, Ofgem issued its final decision letter on modification proposal 0043 under the UNC approving the implementation of this proposal.

### **Responses to the Section 23 Notice**

20. By the close of the consultation period in respect of the Section 23 Notice, the Authority received two responses, none of which were marked as confidential.

None of these responses were withdrawn. The responses have been placed in the Ofgem library and are available on the Ofgem website<sup>4</sup>.

21. In its response, one shipper/supplier recognised that the proposed amendment to the Licence is largely necessary as a consequence of the approval of Modification Proposals 0036 and 0043, as these modification proposals would allow National Grid NTS to limit the amount of System Entry Capacity offered in the various auction and allocation processes. This respondent therefore stated that on the understanding that the modification proposals are likely to be approved, they supported the inclusion of the consent process within the licence provisions.
22. This respondent accepted that the requirement to obtain consent to limit the “all reasonable endeavours” licence obligation may be sufficient, however they would prefer the licence drafting to be more prescriptive, for example, including a requirement to consult the industry on the limitation following publication of the location, scale of limitation and the reasoning behind the limitation.
23. This respondent also considered the impact of the granting of consent to limit the “all reasonable endeavours” licence obligation in respect of unsold obligated (baseline) capacity and the associated UNC consent upon National Grid NTS’s incentive arrangements, noting that the consent process is specifically aimed at avoiding the cost of buybacks which may be incurred by industry more widely but this should not entirely absolve National Grid NTS from its exposure to the consequences of failure to provide obligated capacity.
24. One respondent noted the linkage between the proposed licence modification and Modification Proposal 0043, and expressed a number of concerns with these proposals. However, this respondent stated that, to the extent that Ofgem does approve Modification Proposal 0043, the proposed change to the Licence would be essential to ensure that there is sufficient regulatory oversight of any desire by National Grid NTS to limit the amount of obligated NTS entry capacity it would offer for sale.
25. However, this respondent expressed concern with respect to Modification Proposal 0043 and the licence modification as these proposals would enable NGT to effectively circumvent the NTS SO incentive scheme in a way that was not envisaged at the time the price control was implemented in 2002 and raise new risks for market participants. This respondent stated that these proposals were inappropriate because:
  - the determination of NTS entry capacity baselines was a fundamental building block of the existing NTS entry capacity incentive regime;
  - the NTS SO incentive scheme introduced an element of buyback that was again consulted on and accepted by National Grid NTS as part of the price control package; and
  - the regime that was introduced as part of the NTS SO incentive regime and accepted by National Grid NTS was based upon National Grid NTS’s

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<sup>4</sup> <http://www.ofgem.gov.uk/ofgem/work/index.jsp?section=/areasofwork/gasgovernance>, linked to document 202/05.

assessment of the economic test and the rate of return that would be allowed on incremental capacity.

26. This respondent stated that there should be a fundamental review of the effectiveness of the NTS SO incentive scheme as part of the price control review process with a view to implementing a far simpler, less complex scheme going forward.
27. The Authority has carefully considered the representations made to it and not withdrawn in relation to the proposed modification of Special Condition C8B(14)(5)(f)(ii)(a) of the Licence.
28. In response to the shipper/supplier that requested inclusion, within the licence drafting, of a requirement for National Grid NTS to consult the industry in advance of applying to the Authority for consent to limit the all reasonable endeavours licence obligation, the Authority would note that it is envisaged that, where the licence consent provision proposed is applied, this will be in relation to a parallel request for consent under the terms of the UNC. Whilst the UNC does not require National Grid NTS to consult the industry on such an application, the Authority would note that National Grid NTS has recently undertaken such a consultation. As such, the Authority does not believe that the introduction of additional provisions requiring industry-wide consultation are necessary at this time.
29. Ofgem recognises concerns raised by respondents in relation to interactions with the NTS SO incentives and is of the view that National Grid 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 National Grid NTS's inability to provide the capacity were related to factors beyond its control. In this context, Ofgem would also need to consider National Grid 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, 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.
30. Following consideration of respondents' views, the Authority considers that the proposed licence modifications are consistent with its principal objective to protect the interests of customers and therefore proposes to direct the licence modifications outlined in the Notice.