



National Grid Gas NTS and other interested parties

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Dear Colleague,

Proposed amendment to the Incremental Exit Capacity Release (IExCR) Methodology Statement to support the implementation of the transitional gas exit capacity arrangements

Ofgem¹ has considered the issues raised in the consultation report submitted by the National Grid Gas (NGG) National Transmission System (NTS) business on 4 January 2006 in respect of its proposed revisions to the IExCR Methodology Statement². Having regard to the principal objective and statutory duties of the Authority³, and for the reasons set out in this letter, Ofgem has decided to direct NGG NTS not to make the proposed revisions to the IExCR Methodology Statement pursuant to Special Condition C18(6)(iii) of the NGG NTS Gas Transporter's licence.

This letter outlines the background to the proposed revisions to the IExCR Methodology Statement and gives reasons for Ofgem's decision to direct NGG NTS not to make the proposed revisions.

Background to the consultation

Modification proposal 0046

In August 2005, following Ofgem's decision to delay the implementation of the enduring offtake arrangements, NGG NTS raised Uniform Network Code (UNC) Modification Proposal 0046 (*Extension of the Sunset Clauses for Registration of Capacity at NTS Exit Points*). The modification proposal describes a process through which NTS exit rights may be allocated to NTS connectees (i.e. both Distribution Networks (DNs) and direct connects) and applies for the duration of the transitional period from 1 October 2008 to 30 September 2010. In particular, it relates to a period in which investment by NGG NTS may be undertaken.

¹ Ofgem is the Office of the Gas and Electricity Markets Authority. The terms 'Ofgem' and 'the Authority' are used interchangeably in this letter.

² [http://www.nationalgrid.com/uk/Gas/OperationalInfo/operationaldocuments/Incremental + Entry + Capacity + Release + Model + and + Statement/](http://www.nationalgrid.com/uk/Gas/OperationalInfo/operationaldocuments/Incremental+Entry+Capacity+Release+Model+and+Statement/)

³ Set out in Section 4AA of the Gas Act 1986, as amended.

Under the proposed modification, DNs are able to register and request their NTS capacity holdings three years ahead of use. In addition, DNs will be able to amend their initial capacity requests within investment lead times, and as late as three months before the commencement of the relevant gas year.

It is noted that the modification proposal does not extend to enabling NTS direct connects, through their shipper representatives, to register their capacity holdings three years ahead. Instead, large direct connect customers will continue to have the same rights to the network as at present. In particular, shippers representing directly connected customers will only be required to inform NGG NTS whether they wish to roll-over their current rights of access to the network with one month's notice.

Incremental Exit Capacity Release Methodology

In addition to raising UNC Modification Proposal 0046, NGG NTS issued a consultation, on 25 November 2005, proposing a number of revisions to its IExCR Methodology Statement. Currently, the IExCR Methodology Statement only applies to the interim offtake period, i.e. the period ending 30 September 2008. However, as with UNC Modification Proposal 0046, the proposed revisions to the IExCR Methodology Statement are intended to relate to periods in which investment by NGG NTS can be undertaken (i.e. the transitional offtake period).

Under the proposed revisions to the IExCR Methodology Statement, where a request for capacity from a direct connect or a DN requires the NTS to make an investment in the NTS, it is proposed that NGG NTS will enter into a negotiated agreement with the requesting party. These agreements are known as Advanced Reservation of Capacity Agreements (ARCAs). Under these ARCAs, the connecting party effectively guarantees to pay the relevant transmission charges when the investment is completed and NGG NTS guarantees to compensate the requesting party for any non-delivery of the capacity after a specified date. DNs or direct connects that sign an ARCA will also pay some form of penalty payment to the NTS should they amend their capacity request at a later date to a lower volume of capacity.

It is also noted that to the extent that NGG NTS and the DN/direct connect are unable to agree the terms of an ARCA then the matter may be referred to Ofgem for dispute resolution. Ofgem has recently clarified its position in relation to such disputes through an open letter issued in December and published on the Ofgem website.⁴

It is noted that the proposed revisions to the IExCR Methodology Statement that have been consulted upon include, in Appendix 2, a number of high level principles that will apply to any ARCA offered by NGG NTS. For example, Appendix 2 outlines the principles in relation to the penalties that connecting parties will be required to pay to the extent that they reduce, at a later date, their capacity bookings from the level they originally requested in the ARCA.

Respondents' views to the IExCR Methodology Statement consultation

NGG NTS received nine responses to its November 2005 IExCR Methodology Statement consultation, which are summarised in detail by NGG NTS within its consultation report, which is published on its web-site.

⁴http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/13187_269_05.pdf?wtfrom=/ofgem/work/index.jsp§ion=/areasofwork/transchar

Most respondents to NGG NTS's consultation raised significant concerns that the ARCA principles contained within the proposed revisions to the IExCR Methodology Statement seek to transfer investment risk away from NGG NTS to the relevant connecting DN or direct connect / shipper. In this context respondents noted that an increase in the ARCA commitment could create barriers to entry and increase the cost of credit cover for users. Respondents further stated that that ARCAs should not make connections a risk free business for NGG NTS and that it should provide commensurate compensation in the event that it fails to deliver capacity and that if the proposals are accepted then there should be a consequential reduction in NGG NTS's allowed rate of return.

Respondents indicated that the precedent set by the Langage determination was that one year's exit capacity charges was considered an appropriate level of financial commitment from connectees. Respondents raised concerns that the proposed revisions to the IExCR Methodology Statement require a level of financial commitment from connectees that departs from this precedent.

Some respondents raised concerns regarding the consultation process that had been adopted given the 'scale of changes' proposed. In addition, respondents commented that there has been insufficient overlap between the IExCR Methodology Statement consultation and a related consultation on NGG NTS's proposed DN and direct connect standard form ARCAs.

Ofgem's view

Proposed changes to the IExCR Methodology Statement

In general terms, Ofgem considers that the revision of the IExCR Methodology Statement to reflect the transitional arrangements is necessary to establish a transparent framework that sets out the processes under which NGG NTS will release capacity during a period in which investment by the NTS may be undertaken. The proposed revisions to the IExCR Methodology Statement set out this methodology which provides that:

- ◆ where investment is not required in response to a request for capacity in the transitional period, then the incremental exit capacity will be released to the applicant; and
- ◆ where a request for incremental capacity triggers a need for investment on the NTS⁵, DNs and DCs should enter into an ARCA with NGG NTS.

The proposed revisions to the IExCR Methodology Statement also reflect the provisions of the Gas Act to the extent that it allows a party to refer any dispute regarding the terms of an ARCA to the Authority for determination.

However, whilst Ofgem considers that it is necessary to establish a transparent framework for the release of incremental exit capacity in the transitional offtake period, it has significant concerns with Appendix 2 of the proposed IExCR Methodology Statement, which sets out a number of high level principles that will apply to any ARCA offered by NGG NTS.

In particular, Ofgem is concerned that the principles set out within Appendix 2 of the proposed IExCR Methodology Statement are not sufficiently clear in many respects and that Ofgem's

⁵ Subject to the application of certain defined thresholds.

endorsement of these principles (through a decision not to veto the proposed revisions to the IExCR Methodology Statement) would fetter the Authority's discretion in considering any dispute over the terms of an ARCA referred to it under the Gas Act. Ofgem also notes the concerns of respondents that the principles seek to transfer risk away from NGG NTS. In this respect, Ofgem would note that the principles have largely been developed by only one ARCA counter party, i.e. NGG NTS, and in this respect may not be sufficiently balanced to provide an appropriate allocation of risk. By way of example, in terms of the principles themselves, Ofgem considers that the arrangements that provide NGG NTS with the ability to adjust the delivery date of relevant investments to take account of factors that may be within its control, such as execution of construction agreements, are unclear in their application and potentially inappropriate.

In the light of the arguments outlined above, Ofgem does not wish to provide an endorsement to the principles set out in Appendix 2 of the proposed IExCR Methodology Statement. Ofgem has therefore decided to veto the proposed revision to the IExCR Methodology Statement.

Ofgem however recognises that it is important that there is a finalised version of the IExCR Methodology Statement in place for the transitional offtake arrangements. In this respect, Ofgem would note that were NGG NTS to resubmit its consultation report such that the Final Proposals for the IExCR Methodology Statement excluded Appendix 2 and any references to this Appendix, but were otherwise unchanged, then Ofgem would not veto the resulting IExCR Methodology Statement.

Should NGG NTS continue to wish to publish the principles upon which it will offer ARCAs, NGG NTS could publish a separate paper in this regard outside the IExCR Methodology Statement.

High level principles

Ofgem considers that in the absence of the enduring offtake arrangements which provide for non-discriminatory allocations of offtake capacity to all users of the NTS, any financial arrangements for the transitional period would need to be resolved on a case by case basis having regard to the individual circumstances of each request for incremental offtake capacity.

Ofgem however recognises that industry participants will need some certainty throughout the transitional offtake arrangements regarding the principles under which ARCAs should be agreed. In the following section, Ofgem sets out some of the principles which it considers parties should have regard to in agreeing the terms and conditions of any ARCA. In setting out these principles Ofgem recognises that ARCAs are commercial agreements and that the parties are not bound by these principles. However, without fettering the discretion of the Authority, it is likely that the Authority will have regard to these principles in considering the terms and conditions of any ARCA that is referred to it for dispute resolution.

First, Ofgem considers that it is important that connectees provide some form of financial commitment to underpin investments in the network that they benefit from. Such financial commitments should facilitate efficient investment and reduce the risk of stranded assets. However, it is also important that any such financial commitments do not unduly discriminate between new and existing users.

In this respect, it is important to note that NGG NTS, in agreeing the terms and conditions of any ARCAs, is subject to its statutory and licence obligations including those relating to non-discrimination and the efficient development and maintenance of the pipeline system.

Given this background, Ofgem considers that NGG NTS should, in determining the level of any financial commitments associated with an incremental offtake capacity request, have regard to the risk profile of the load making the request relative to other present and future loads in the area, including:

1. The extent to which the investments or reinforcements in the relevant area in which the load making the request for incremental capacity (eg a new connecting load) is located would benefit other users in the future and the level of risk associated with these future loads. In this respect, any financial commitments should ensure that the load making the request for incremental capacity does not face a disproportionately high exposure to the costs of investment that does not take into account the benefits the relevant investments provide to other users; and
2. The nature and risks associated with the existing portfolio of load already in the area in which the connecting party is intending to locate. For example, whether there are other relatively risky loads in the area that may in the future reduce their usage of the network thereby releasing spare capacity to the party making the capacity request. Ofgem would note that this question should be determined on a case by case basis as existing users do not signal their future requirements for offtake capacity under the transitional offtake arrangements.

In summary, Ofgem considers that NGG NTS should request financial commitments that are commensurate with the risks identified associated with the load requesting the incremental capacity relative to other loads in the area. Naturally these risks will differ depending on the load in question that is seeking the incremental capacity and the topography of the network in which the load is located or intending to connect.

The Langage determination

In relation to the comments made by respondents which compared the ARCA principles set out in the proposed IExCR Methodology Statement with those embodied by the Langage determination, it is Ofgem's view that the Langage determination, in so far as it relates to the treatment of ARCAs, should not necessarily be viewed as a precedent for all future ARCAs. In particular, as noted above, Ofgem considers that the level of financial commitment payable by a party seeking incremental offtake capacity should be dependent upon the level of risk associated with the load in question relative to other present and future loads in the area.

The consultation process

Ofgem notes the concerns raised by respondents regarding the consultation process. However, Ofgem would emphasise that, as noted in its open letter of 15 December, there is no express power of the Authority to review or approve either DC or DN ARCAs. Furthermore, Ofgem would note that there is no explicit requirement upon NGG NTS to consult upon the proposed ARCAs. As noted above should NGG NTS continue to wish to publish the principles upon which it will offer ARCAs, or consult on them further, NGG NTS could publish a separate paper in this regard outside the IExCR Methodology Statement.

Ofgem's decision

Following consideration of the documentation provided (including responses to NGG NTS's consultation on the proposed revisions to the IExCR Methodology Statement) and having regard to the Authority's principal objective and statutory duties, and for the reasons set out above, the Authority hereby directs NGG NTS, pursuant to Special Condition C18(6)(iii) of its Gas Transporter's licence, not to make the proposed revision to the IExCR Methodology Statement as submitted to the Authority on 4 January 2006.

Pursuant section 38A of the Gas Act 1986, this letter constitutes a notice of reasons for the purposes of this direction.

Ofgem does not believe that it would be appropriate to approve UNC Modification Proposal 0046 (and hence commence the capacity allocation process for the transitional period) until it is clear that an appropriate methodology for the release of incremental exit capacity will be in place throughout the capacity allocation process for the transitional period.

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 assist.

Yours sincerely

Robert Hull
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Authorised on behalf of the Authority