Modification proposal:	**Uniform Network Code (UNC) 439: Notice for Enduring Annual Exit (Flat) Capacity Reduction Applications (UNC439)**		
Decision:	The Authority[1] directs that this proposal be made[2]		
Target audience:	The Joint Office, Parties to the UNC and other interested parties		
Date of publication:	21 June 2013	Implementation Date:	To be confirmed by the Joint Office

Background to the modification proposal

National Gird Gas plc (NGG) is the Transmission Owner (TO) of the GB National Transmission System (NTS) for gas transportation. Gas shippers and gas distribution network (GDN) operators must book NTS exit capacity from NGG in order to secure the right to flow gas from the NTS to gas customers. The long term capacity product associated with exit capacity is known as Enduring Annual NTS Exit (Flat) Capacity. Enduring Annual NTS Exit (Flat) Capacity bookings help NGG to plan its network, and, where additional capacity is required, to plan investment.

When an NTS user books additional Enduring Annual NTS Exit (Flat) Capacity, that user becomes liable for a financial user commitment on that additional capacity. The NTS user must then remain either the registered user of the additional capacity for four years after the increased capacity allocation becomes effective, or pay, by way of capacity charges, the User Commitment Amount (UCA). The UCA is intended to protect the generality of gas customers from financial exposure to the risk that the additional investment is ultimately not needed, and is equal to four years worth of the indicative exit capacity charge at the exit point at the time of the booking. As actual charges may be greater than indicative charges, a user may therefore pay the UCA within four years.

NTS users who would like to reduce their exit capacity bookings can do so via the capacity reduction window held in July each year. Under the current arrangements there is normally a 14 month lead time for reductions. However, implementation of modification UNC417S[3] in July 2012 removed the 14 month lead time for Enduring Annual Exit (Flat) Capacity reductions where a user is expected to satisfy a UCA within 12 months of the first day of the incremental capacity booking taking effect. Users who satisfy this criterion can effect a capacity reduction from the first day of any month following the UCA being satisfied. This is subject to a minimum two month lead time. That day must be on or after the 1 October following the July reduction window.

UNC417S was intended to provide users with the option of protection from unexpected and significant changes in the level of exit charges which as a consequence of the 14 month notice period, would have resulted in a financial exposure greater than the UCA. The proposal did not remove the 14 month lead time for users not expected to satisfy a UCA within 12 months of an incremental capacity booking taking effect, or for users not subject to a UCA[4].

The modification proposal

[1] The terms 'the Authority', 'Ofgem' and 'we' are used interchangeably in this document. Ofgem is the Office of the Gas and Electricity Markets Authority.
[2] This document is notice of the reasons for this decision as required by section 38A of the Gas Act 1986.
[3] For more information please see: http://www.gasgovernance.co.uk/0417
[4] The proposal did not consider these users directly. Users with a UCA expected to be paid within 12 months of an incremental capacity booking taking effect were considered the priority for the proposal.

The proposal seeks to remove the 14 month lead time for the reduction of Enduring Annual Exit (Flat) Capacity for all NTS users. This is subject to one of two conditions, either: (a) there should be no outstanding UCA; or (b) any outstanding UCA is forecast to be satisfied by the requested date of the capacity reduction. Users would be able to reduce their capacity bookings with effect from the first day of the month after the UCA has been paid or is forecasted to be paid, providing that date is no earlier than 1 October of the next gas year[5].

UNC Panel[6] recommendation

The UNC Panel met on 16 May 2013 and voted unanimously in favour of recommending implementation of the proposal.

Our decision

We have considered the issues raised by the modification proposal and the Final Modification Report (FMR) dated 16 May 2013. We have considered and have taken into account the responses to the Joint Office's consultation on the modification proposal which are attached to the FMR[7] and have concluded that:

1. the implementation of the modification proposal will better facilitate the achievement of the relevant objectives of the UNC[8]; and
2. directing that the modification be made is consistent with our principal objective and statutory duties[9].

Reasons for the Authority's decision

We consider that implementation of the proposal will better facilitate relevant objectives (d) and (g), and that it is neutral with respect to the remaining relevant objectives. The reasons for our views are set out below. In reaching our decision we have considered the responses to the consultation on the proposal. Eleven consultation responses were received, each in support of implementation. The only issue of concern among the responses was raised by NGG, relating to the overall volatility of TO exit charges. This is discussed further under relevant UNC objective (d) below. We note in respect of this issue, and of the proposal in general, that although users who choose to affect short term capacity reductions may see a reduction in the level of their charges, the proposal does not affect NGG's allowed revenues. We do not therefore expect implementation to have a significant effect on customers' energy bills.

SSC A11(1)(a)"Efficient and economic operation of the pipeline system"

[5] Gas Years run from 1 October to 30 September. Under the proposed new arrangements, if a user were to make an application to reduce capacity in July in Gas Year Y, and it does not have any UCA to satisfy, the reduction would take effect from 1 October in Gas Year Y+1 (that same calendar year). Currently, this user would have to wait until 1 October in Gas Year Y+2 (the next calendar year) for this reduction to take effect.

[6] The UNC Panel is established and constituted from time to time pursuant to and in accordance with the UNC Modification Rules

[7] UNC modification proposals, modification reports and representations can be viewed on the Joint Office of Gas Transporters website at www.gasgovernance.com

[8] As set out in Standard Special Condition A11(1) of the Gas Transporters Licence, see: http://epr.ofgem.gov.uk/Pages/EPRInformation.aspx?doc=http%3a%2f%2fepr.ofgem.gov.uk%2fEPRFiles%2fStandard+Special+Condition+PART_A_-_Consolidated_-_Current+Version.pdf

[9] Our statutory duties are wider than matters which the Panel must take into consideration and are detailed mainly in the Gas Act 1986.

The FMR states that the proposal better facilitates relevant objective (a). This view was supported by one of the respondents to the consultation. It is based on the premise that allowing users to reduce their capacity holdings at lead times shorter than 14 months will allow NGG to make that capacity available for use by other users, thereby promoting the efficient and economic operation of the pipeline system. We agree that the proposal may lead to a more efficient *allocation* of capacity. However, but we do not consider that this necessarily has an impact on the economic and efficient *operation* of the NTS. We consider that the proposal is neutral in respect of relevant objective (a).

SSC A11(1)(c) the efficient discharge of the licensee's obligations under this licence

Under its licence NGG has an obligation to ensure that the NTS is developed in an efficient and economic manner[10]. One respondent to the consultation considered that the proposal better facilitated discharge of this obligation, and in the FMR the panel agreed that this was the case. The respondent considered that increased flexibility for exit capacity reductions would provide users with greater certainty of their financial exposure when making incremental capacity commitments and that this in turn would provide NGG with more efficient signals for system development.

We agree that Enduring Annual NTS Exit (Flat) Capacity bookings, underpinned by the UCA arrangements, provide NGG with signals about users' long term capacity needs. In our view these signals are integral to the decisions NGG takes on the economic and efficient development of the NTS. However, we are not aware of situations where the 14 month capacity reduction lead time has inhibited efficient incremental capacity bookings to date, and have not been provided with evidence in this case to demonstrate that the change would provide NGG with more efficient signals than the current arrangements. For this reason we do not think there is sufficient evidence to support the view that the proposal will directly affect the efficient and economic development of the system, nor consequently that it will better achieve relevant objective (c).

SSC A11(1)(d) the securing of effective competition: (i) between relevant shippers; (ii) between relevant suppliers; and/or (iii) between DN operators

We consider that the proposal will better facilitate competition between shippers in two ways. First of all, providing any outstanding UCA has been discharged, the proposal will allow shippers greater flexibility to adjust their capacity bookings to their capacity needs. This reduces the possibility that shippers will be required to maintain and pay for capacity that they no longer need. In our view this will lead to a more efficient allocation of costs between users. All other things being equal, we would expect this to allow efficient users to put downward pressure on prices to the benefit of competition in the sector.

Secondly, the proposal removes any potential discrimination between shippers arising from the implementation of UNC417S. UNC417S removed the 14 month capacity reduction lead time for those users with a UCA forecast to be discharged within 12 months of an incremental capacity booking taking effect, but it did not remove the lead time for users with a UCA to whom this criterion did not apply, or for users not subject to a UCA. This differential treatment could result in relevantly similar users being subject to different levels of exposure to exit capacity charges i.e. one category can reduce within 14 months, the other cannot. The proposal removes this possibility by applying the same rules for capacity reductions to all categories of user.

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[10] Standard licence condition 9 requires the licensee to establish transportation arrangements which are, among other things, consistent with the licensee's duties under section 9 of the Gas Act. Section 9 of the Gas Act requires the gas transporter to 'develop and maintain an efficient and economical pipeline system'.

In its consultation response NGG indicated that implementation of the proposal could increase the volatility of the TO exit commodity charge. NGG considered that this aspect of the proposal could be viewed as having a detrimental effect on competition. NGG levies a TO exit commodity charge on network users to recover the share of its TO allowed revenues not recovered through TO exit capacity charges. Indicative TO exit commodity charges are published in May each year. These rates are based on a forecast level of exit capacity bookings for the coming gas year. Actual TO exit commodity charges are published on 1 August. If expected capacity revenue falls, as a consequence of shorter capacity reduction lead times, an increase in the actual level of the TO exit commodity charge would be applied.

In our view it is appropriate for NGG to highlight this risk. However, on the basis of the uncertainty as to whether the effect will be realised, the relatively limited materiality of the issue, the availability of potential remedies and NGG's view that the benefits of the proposal outweigh the risk, we do not consider that the issue is significant enough to change our assessment that the proposal better facilitates this relevant objective. NGG has indicated that a reduction in forecast exit capacity revenue of 10% could result in an increase to the TO exit commodity charge of approximately 0.0018p/kWh (equivalent to a 16% increase on the April 2013 TO exit commodity charge). However, the likelihood of a 10% level of short term capacity reductions has not been provided, and no evidence has been provided to suggest that implementation of the proposal will significantly increase the volume of capacity reduction requests made via the annual capacity reduction window. In our view, NGG and other UNC parties have the tools to monitor and, if necessary, to address this issue, including raising further modification proposals to counter the risk if appropriate.

SSC A11(1)(g) compliance with European Regulation

Article 16(2) of EC Regulation 715/2009 requires transmission operators to implement *"non-discriminatory and transparent capacity allocation mechanisms, which shall: a) provide appropriate economic signals for the efficient and maximum use of technical capacity".* We consider that proposal will better facilitate the regulation, and therefore relevant objective (g), for two reasons:

1. It ensures that the 14 month lead time is removed for all users, rather than just for certain users. In our view, this is consistent with the requirement to implement non-discriminatory capacity allocation mechanisms;
2. Removing the 14 month lead time would increase users' ability to respond to any changes in exit capacity charges, and where capacity reductions are affected, could potentially make released capacity available to other users. In our view, both of these effects better facilitate the requirement to provide appropriate economic signals for the efficient and maximum use of capacity.

Decision notice

In accordance with Standard Special Condition A11 of the Gas Transporters Licence, the Authority hereby directs that modification proposal UNC 439: 'Notice for Enduring Annual Exit (Flat) Capacity Reduction Applications' be made.

Andy Burgess, Associate Partner, Smarter Grids and Governance
Signed on behalf of the Authority and authorised for that purpose.