

The Joint Office, Relevant Gas
Transporters and other interested
parties

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Dear Colleague,

4 October 2005

Modification proposal 0043 'Limitation on offering for sale unsold capacity'

Ofgem¹ has considered the issues raised in the modification report in respect of modification proposal 0043 '*Limitation on offering for sale unsold capacity*' and, having regard to the principal objective and statutory duties of the Authority², has decided to direct the relevant gas transporters to implement modification proposal 0043.

Background to the proposal³

On 10 August 2005 Transco National Transmission System (NTS) raised urgent modification proposal 0043 '*Limitation on offering for sale unsold capacity*'. This modification proposal provided Transco NTS with the discretion, in the context of its licence obligations, to not offer baseline and obligated incremental capacity for sale (through the long, short and medium term auctions) at any system entry point under certain circumstances.

Initial views letter⁴

On 25 August 2005, Ofgem issued a letter for consultation providing its initial views on this modification proposal (the 'initial views' letter).⁵ In this letter Ofgem stated that, without fettering the Authority's discretion with respect to modification proposal 0043, and having considered 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 the proposal is finely balanced but should be approved subject to certain amendments to the legal text being made.

Ofgem considered 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. Ofgem considered that 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 was that any such consent process would need to be

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

³ For a more detailed description of the background to the proposal, please refer to the initial views letter and the way forward letter.

⁴www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/12234_193_05.pdf?wtfrom=/ofgem/work/index.jsp§ion=/area/sofwork/gasgovernance

⁵ Note that on 26 August Ofgem issued an addendum to the initial views letter. The addendum was circulated via email by the Joint Office of Gas Transporters.

completed prior to the holding of this year's LTSEC auctions. Further, Ofgem also noted that whilst it was minded to approve this proposal, it would not expect to grant such approval until such time as the formal consent process referred to above was established.

Way forward letter⁶

On 13 September 2005, following consideration of responses to the initial views letter, Ofgem issued a letter setting out its views on this proposal and a way forward⁷ (the 'way forward' letter). In this letter Ofgem reiterated its views on this modification proposal. In addition, Ofgem noted the concerns that had been raised by respondents regarding the interaction between this modification proposal and Transco NTS's licence obligations to use all reasonable endeavours to offer for sale baseline capacity and obligated incremental capacity in a clearing allocation⁸, as set out in Special Condition C8B(14)(5)(f)(ii)(a) of its GT licence.

With a view of clarifying this interaction, Ofgem noted that the terms and conditions of the UNC cannot 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 of any other licence obligation. In this context, Ofgem stated that in the event that this modification proposal is implemented, 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 except where the Authority otherwise consents.

Ofgem also considered that it would be appropriate 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 within the UNC, as envisaged in the modification proposal itself. In version 3.0 of the final modification report on modification proposal 0043, dated 14 September 2005, Transco NTS provided a revised drafting of the legal text of the modification proposal, which explicitly referred to the Authority consent process.

Ofgem also recognised the concerns that respondents had expressed on the potential interaction between modification proposal 0043 and the incentives and price control framework set for the present price control period. In this context, Ofgem noted that it would need to be satisfied that the reasons for Transco NTS's inability to provide the capacity were related to factors beyond its control.

Licence consultation

On 14 September 2005, Ofgem initiated a formal consultation under section 23 of the Gas Act proposing to 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. This formal consultation will close on 12 October, and it is expected that Ofgem will issue a decision on the proposed licence amendments on 14 October.

⁶www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/12318_20105.pdf?wtfrom=/ofgem/work/index.jsp§ion=/areas/ofwork/gasgovernance

⁷ This letter also set out Ofgem's views on modification proposal 0036 'Limitation of incremental capacity offered in QSEC auctions'.

⁸ 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.

Transco consultation

On 21 September 2005 Transco NTS also issued a document which consulted industry participants on a potential application to the Authority for consent not to release the amounts of unsold capacity in the 2005 Quarterly System Entry Capacity (QSEC) auction of entry capacity at the Milford Haven entry point for calendar quarters over the period October 2007 to September 2008. This consultation will close on 5 October 2005 and Transco NTS is expected to deliver a report on this consultation and a formal submission to the Authority requesting consent to limit volumes of capacity to be made available for sale at the Milford Haven entry terminal.

The Modification Proposal

In summary, the proposal is to amend the relevant paragraphs in section B of the UNC in order to give Transco NTS the discretion to NOT make available certain unsold NTS entry capacity, including baseline and obligated incremental capacity, for sale at any system entry point in certain circumstances. In particular, the availability of unsold capacity would be excluded for each gas day within certain calendar quarters when the following criteria are met for QSEC Auctions conducted within the current formula period (i.e. up to March 2007):

- 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.

Transco NTS noted 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 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. As noted before, the legal text of the proposal was amended to include this requirement.

Respondents' views

Eight responses were received in relation to modification proposal 0043. One respondent supported the modification proposal, while seven responses stated that they were not in favour of the implementation of this modification proposal. The views expressed by these respondents were summarised in the 'initial views' letter.

Of the seven respondents to the 'initial views' letter (excluding the proposer – Transco NTS), six expressed opposition to the implementation of Modification Proposal 0043 and one respondent stated that it was not possible to come to a definitive view on this modification proposal whilst it is at an early stage of development. A summary of the responses received is provided in the 'way forward' letter.

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 the modification proposal. Therefore the panel did not recommend implementation of the proposal.

Ofgem's view

Ofgem has carefully considered the views raised by all parties in relation to modification proposal 0043.

Having had regard to the principal objective and the statutory duties of the Authority, Ofgem considers that this modification proposal better facilitates the relevant objective (a) as set out in paragraph 1 of Standard Special Condition A11 (Network Code and Uniform Network Code) in the Gas Transporters Licence.

Standard Special Condition A 11(1) (a) – the efficient and economic operation of the pipe-line system to which this licence relates

In the 'initial views' letter Ofgem considered that there may be limited circumstances where it is necessary for Transco NTS 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. For example, 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.

However, whilst Ofgem noted in the initial views letter that there may be good reasons for granting Transco NTS discretion to limit the amount of unsold obligated entry capacity that it is required to offer for sale, such 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 broad discretion may undermine the incentives that have been placed on Transco NTS.

Further, Ofgem noted 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 the market.

Therefore Ofgem considered that it is important that any exercise of 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 noted before, Transco NTS has submitted revised legal drafting of the UNC, which requires Transco NTS to obtain the consent of the Authority before limiting unsold obligated entry capacity for sale. In addition, as noted above, a formal consultation under section 23 of the Gas Act has been issued in order to introduce a parallel consent process under the licence. It is noted that Transco NTS has now separately informed Ofgem that it is willing to consent to the proposed licence changes.

Whilst Ofgem will need to consider the views of respondents to the licence consultation before considering whether to direct the changes, Ofgem nevertheless considers that the shortcomings of this UNC modification proposal, relating to the degree of discretion granted to Transco NTS, have now been sufficiently addressed by the inclusion of a formal consent process within the UNC.

On this basis Ofgem considers that the proposal better facilitates the relevant objective (a) as set out in paragraph 1 of Standard Special Condition A11. In particular, this proposal should better facilitate the efficient operation of Transco NTS's pipeline system by allowing Transco NTS the flexibility to limit the volumes of unsold capacity made available for sale to take account of factors beyond its control, with the consent of the Authority. In particular, the proposal should ensure that Transco NTS is not required to offer for sale capacity that it cannot deliver for reasons beyond its control. This should protect shippers and therefore customers from any potential buy back costs that may have otherwise accrued from the sale of such capacity.

Standard Special Condition A11(1)(d) – securing of effective competition between the relevant shippers and suppliers

In the 'initial views' letter, Ofgem recognised the concerns of respondents regarding the impact of this proposal on competition between shippers, and noted that this proposal is unlikely to have the effect of securing effective competition between shippers and suppliers.

However, Ofgem considers 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 buyback costs with the potential impacts of such a limitation on competition.

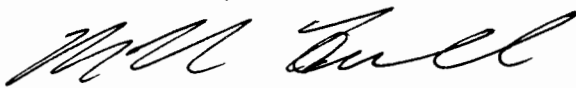
Accordingly therefore, whilst the proposal may not better facilitate competition between shippers, Ofgem considers that it does better facilitate the efficient and economic operation of Transco NTS's pipeline system and that on balance the proposal should be approved.

Ofgem's decision

For the reasons outlined above, Ofgem has decided to accept modification proposal 0043.

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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