



The Joint Office, Relevant Gas
Transporters and other interested
parties

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4 October 2005

Dear Colleague,

Uniform Network Code modification proposal 0036 'Limitation of incremental capacity offered in QSEC auctions'

Ofgem¹ has considered the issues raised in the final modification report in respect of modification proposal 0036 '*Limitation of incremental capacity offered in QSEC auctions*' 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 0036.

This letter outlines the background to the modification proposal and gives the reasons for the decision.

Background to the proposal³

On 18 July 2005 Transco National Transmission System (NTS) raised urgent modification proposal 0036 '*Limitation on incremental capacity offered in QSEC auctions*'. This modification proposal provided Transco NTS with a degree of flexibility to specify revised lead times for the delivery of any incremental capacity that is allocated in the long term auctions. Transco NTS stated that the proposal would have the advantage of ensuring consistency between the UNC and the relevant provisions of the Incremental Entry Capacity Release (IECR) methodology statement, in particular the change made in July 2005 allowing Transco NTS to specify a longer lead time than three years 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). In this letter Ofgem stated that, without fettering the Authority's discretion with respect to modification proposal 0036, and having considered the proposal against the relevant objectives of the UNC as well as the Authority's principal objective and statutory duties, its initial view was that the proposal should be approved. However, Ofgem

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

⁴ www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/12233_192_05.pdf?wtfrom=/ofgem/work/index.jsp§ion=/area/sofwork/gasgovernance

had some concerns relating to the degree of discretion that both the proposal and the latest version of the IECR provided Transco with respect to extending the lead times associated with the provision of incremental capacity. Ofgem's initial view was that there would be merit in proposing modifications to Transco's NTS GT licence, or for Transco NTS to propose modifications to its IECR, to incorporate a formal process through which Transco NTS would require the Authority's consent before it would be able to adjust the lead times for the provision of incremental entry capacity. Ofgem noted that it did not expect to approve the proposal until such time as a formal consent process was established. In addition, Ofgem's initial view was that, in the event that Transco NTS wishes to extend the lead times for the delivery of incremental capacity, it would be preferable for Transco NTS to consult industry participants on the proposed change in advance of the long term auctions.

Way forward letter⁵

On 13 September 2005, following consideration of responses to the initial views letter, Ofgem issued a letter setting out its further views on this proposal and a way forward⁶ (the 'way forward' letter). In this letter Ofgem reiterated its views on this modification proposal. Ofgem also considered that it would be preferable for the formal consent process to be incorporated within the framework of the IECR statement, as it is the IECR which governs the process by which Transco NTS determines whether to release incremental entry capacity. Ofgem however noted 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 believed 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.

In the 'way forward' letter, Ofgem also reiterated its 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 initial views letter, Ofgem considered 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.

IECR consultation

On 14 September 2005 Transco initiated a consultation proposing a number of revisions to the IECR statement in order to introduce a formal consent process. The proposed revisions provided that Transco NTS needs to apply for the written consent of the Authority in order to adjust the lead time for all or part of the incremental capacity to be released at a System Entry Point and must first consult industry participants on its application. Today Ofgem published a letter⁷ in which it stated that the proposed changes to the IECR statement would not be vetoed.

Consultation on lead time changes

On 21 September 2005 Transco NTS also issued a document which consulted industry participants on a potential change in investment lead times at two entry terminals (Easington and Milford Haven). This consultation will close on 5 October 2005 and Transco NTS is expected to

⁵www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/12318_20105.pdf?wtfrom=/ofgem/work/index.jsp§ion=/areas/ofwork/gasgovernance

⁶ This letter also set out Ofgem's views on modification proposal 0043 'Limitation on offering for sale unsold capacity'

⁷ Proposed amendment to the IECR methodology statement to introduce a formal consent process to adjust investment lead times, open letter

deliver a report on this consultation and a formal submission to the Authority requesting consents to revise lead times under the IECR.

The Modification Proposal

In summary, the proposal is to amend paragraphs B2.2.3(c)(i) and B2.2.18(d)(v)(1) of the UNC, and in particular to change the maximum incremental amount in respect of quarterly NTS entry capacity for years +2 to +16 specified in the invitations for annual NTS capacity auctions at entry points and for NTS capacity auctions at new entry points such that it is the lower of not less than an amount equal to 150% of NTS SO baseline entry capacity and an amount determined in accordance with Transco NTS's IECR.

In making the proposal, Transco NTS stated that the modification would have the advantage of ensuring consistency between the UNC and any relevant provisions of the IECR, in particular the change made in July 2005 allowing Transco NTS to specify a longer lead time than three years where it assesses, prior to the auction invitation, that it "may be unable to physically deliver all or part of anticipated incremental capacity within a three year lead time".

Respondents' views

Nine responses were received in relation to modification proposal 0036, of which seven were non-confidential responses. Of the seven non-confidential responses, one respondent supported the modification proposal, two respondents offered qualified support and four respondents were not in support. The two confidential respondents did not support the proposal. The views expressed by these respondents were summarised in the 'initial views' letter.

Of the five respondents to the initial views letter that stated explicitly whether they supported the implementation of modification proposal 0036, three respondents stated their qualified support, one respondent stated its opposition and one respondent stated that it was not possible to come to a definitive view at this stage. A summary of the responses received is provided in the 'way forward' letter.

Panel recommendation

Of the ten voting members of the modification panel, one voted in favour of recommending the implementation of this 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 0036, both in response to the proposal and Ofgem's initial views letters.

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

As noted in the 'initial views' letter, Ofgem considers that there may be limited circumstances where it is necessary for Transco's NTS business to have the ability to extend investment lead

times and therefore lead times for the delivery of incremental capacity, to take account of factors beyond its control, such as some aspects of the planning consents process.

However, as also noted in the initial views letter, Ofgem considers that it is important that such flexibility is not used to delay the delivery of incremental capacity on account of poor planning or project management on the part of Transco NTS. Indeed, the provision of such flexibility may undermine the incentives that have been placed on Transco NTS. In particular, if Transco NTS fails to deliver capacity for reasons that are within its control then it should face exposure under its buy back incentive scheme.

In addition, as noted in Ofgem's initial views letter, 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 market.

Therefore, Ofgem considers that it is important that any exercise of discretion to adjust investment lead times 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.

Ofgem notes that a formal consent process has now been introduced within the IECR such that Transco NTS requires the approval of the Authority before it is able to adjust investment lead times and which requires Transco NTS to consult on any application that it may wish to make in seeking the Authority's consent to adjust lead times. On this basis, Ofgem considers that the previous shortcomings of the proposal (as identified in the initial views letter) have been sufficiently addressed by Transco NTS. As such, 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 adjust investment lead times to take account of factors beyond its control (with the consent of the Authority) and by reflecting these adjustments on an ex ante basis through the auction invitation to tender process. In particular, the proposal should ensure that Transco NTS is not required to offer for sale incremental 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 had the relevant incremental capacity been offered for sale under a three year lead time.

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

In the 'initial views' letter, Ofgem considered that it is preferable for Transco NTS to notify industry participants of proposals to extend investment lead times in advance of the long term auctions, in order to assist shippers in preparing efficient capacity booking strategies ahead of the auctions, therefore this modification should not be detrimental to the securing of effective competition between shippers.

As noted above, the approval process introduced within the IECR comprises an industry-wide consultation, which should allow industry participants to be notified of the proposed changes sufficiently in advance of the long term auctions.

Ofgem's decision

For the reasons outlined above, Ofgem has decided to accept modification proposal 0036.

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

A handwritten signature in black ink, appearing to read 'R Hull', written in a cursive style.

Robert Hull
Director, Transmission