ofgem

Modification proposal:	**Uniform Network Code (UNC) 119: Amendment to the Entry Overrun Charge**		
Decision:	**The Authority[1] has decided to reject this proposal**		
Target audience:	**The Joint Office, Parties to the UNC and other interested parties**		
Date of publication:	**27 March 2007**	Implementation Date:	**N/A**

Background to the modification proposal

Under the current UNC arrangements users intending to deliver gas at an Aggregate System Entry Point (ASEP) are provided the opportunity to purchase National Transmission System (NTS) entry capacity through various capacity auctions. This is to provide user commitment signals to National Grid Gas (NGG) NTS. If a user delivers gas onto the NTS over a gas flow day at an ASEP in excess of the level of NTS entry capacity holdings that it has purchased, then the user incurs an overrun charge.

The overrun charge is based on the quantity of gas by which the user has overflowed its NTS entry capacity holding (the overrun quantity) multiplied by an overrun price. The overrun price aims to encourage users to purchase NTS Entry Capacity consistent with their flow requirements.

The proposer, NGG NTS, considers that the current methodology for deriving the overrun price potentially has two unintended consequences, which are:

- the possibility to have a zero overrun price, so that overruns avoid any overrun charge
- that some users could obtain more revenue from the surrender of NTS entry capacity through the capacity management processes than they have to pay in overrun charges, which could act as an incentive on these users to overrun.

These could result in distortions of the signals being made by users through the auction processes.

The modification proposal

UNC119 seeks to address the two potential consequences highlighted above by revising the methodology for calculating the overrun charge. It proposes that the overrun charge should be the overrun quantity multiplied by the greater of:

- (8 * A), where A is the highest bid price which NTS entry capacity was allocated following an entry capacity auction in which the gas flow day falls
- (1.1 * B), where B is the highest accepted offer price, highest accepted forward price or highest accepted option price paid by NGG NTS for any capacity management action taken on that gas flow day
- (8 * C), where C is the highest reserve price specified in an invitation to the auctions in which the gas flow day falls.

This differs from the current arrangements in that B is calculated using the highest of the stated prices rather than an average, and the inclusion of the highest reserve price in the criteria for determining the overrun charge.

[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.

UNC Panel[2] recommendation

At its meeting on 21 December 2006, the Modification Panel voted in favour of implementing the modification proposal.

The Authority's decision

The Authority has considered the issues raised by the modification proposal and the Final Modification Report (FMR) dated 22 December 2006. The Authority has considered and taken into account the responses to the Joint Office's consultation on the modification proposal which are attached to the FMR[3].

The Authority has concluded that implementation of the modification proposal will not better facilitate the achievement of the relevant objectives of the UNC[4].

Reasons for the Authority's decision

Relevant objective (a) – the efficient and economic operation of the pipe-line system to which this licence relates

The proposer and two respondents think that relevant objective (a) would be better facilitated by UNC119 as it would result in more accurate signals from entry capacity auctions.

Ofgem notes this view but considers that the larger penalty that shippers could face from overruns under UNC119 may have perverse incentives on shippers to give greater weight to the risk they faced from overruns than would be the case under the current arrangements. This could result in shippers being overly conservative when providing user-commitment signals through the auction processes and as a result NGG would receive negatively biased user commitment signals.

The proposer and some of the respondents argue that UNC119 would remove the incentives on shippers to benefit from overruns such as the potential financial benefits from the interaction with the buy back regime. The implication is that shippers operating in this way would be to the detriment of economical and efficient operation of the NTS.

However, a number of respondents argued that there was little evidence of this behaviour and Ofgem, after investigating for evidence of such shipper behaviour, agrees.

Ofgem therefore considers that due to the greater potential for negatively biased user commitment signals the NTS may not be operated in a more efficient and economic manner if UNC119 were implemented. Furthermore, there appears to be very little evidence of the unintended consequences which UNC119 aims to address.

Relevant objective (d)(i) – so far is consistent with relevant objectives (a) to (c) the securing of effective competition between relevant shippers

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[2] The UNC Panel is established and constituted from time to time pursuant to and in accordance with the UNC Modification Rules.
[3] UNC modification proposals, modification reports and representations can be viewed on the Joint Office of Gas Transporters website at www.gasgovernance.com
[4] As set out in Standard Special Condition A11(1) of the Gas Transporters Licence, see: http://62.173.69.60/document_fetch.php?documentid=6547

One respondent considered that cost allocation resulting from overruns should be accurately allocated in order to facilitate effective competition between relevant shippers.

Ofgem has noted this view and considers that in moving to a more marginal overrun price, which also includes an additional component, UNC119 may not allocate more accurately the costs resulting from an overrun. Moving to a more marginal overrun price has a number of concerns including the possibility that the overrun price may be set by a small quantity of entry capacity with a very high price, which would therefore not be representative of NGG's costs. Furthermore, the inclusion of the highest reserve price specified in the auction invitation, in determining the overrun price, is problematic as it does not relate to the possible costs incurred by NGG as a result of overruns.

This lack of reflecting the possible costs incurred as a result of an overrun means that a shipper which is penalised in this manner is likely to pay a different charge than the cost their actions resulted in. This would put such a shipper at a disadvantage to other shippers when the penalty is higher than the actual costs incurred as a result of the overrun, and vice versa. Therefore Ofgem considers that implementing UNC119 would not better facilitate effective competition between shippers.

Wider statutory duties

The potential results of UNC119 in frustrating the efficient and economic operation of the NTS through negatively biased user commitment signals given by shippers in auctions and potentially hindering more effective competition between shippers would not help in facilitating the principal objective of the Authority to protect the interests of consumers.

Furthermore, security of supply could be undermined in the long run by UNC119 if user signals through the auction process are conservative and insufficient to trigger the level of investment needed to meet actual demand.

Presentation of Final Modification Reports

Ofgem notes that the legal text in the FMR includes minor errors which would have needed to be revised for good house-keeping of the UNC if UNC119 had been approved.

Ofgem has observed these text errors in relation to a number of reports and considers that had the proposal been developed via an appropriate Workgroup the overall quality of the textual drafting may have been improved and minor errors like these would be less likely to materialise. Ofgem asks all relevant parties to exercise increased diligence in relation to production of legal text for future modification reports.

Robert Hull
Director of Transmission
Signed on behalf of the Authority and authorised for that purpose.