Modification proposal:	**Uniform Network Code (UNC) 0262: Treatment of Capacity affected by Force Majeure**		
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:	9 December 2009	Implementation Date:	N/A

Background to the modification proposal

Under the current Uniform Network Code (UNC) arrangements, on occasions when National Grid NTS issues a Force Majeure (FM) notice (under UNC General Terms Section B General), NGG NTS is relieved from its UNC requirement to make payment for any delay or failure in the performance of its obligations under the UNC. In relation to NTS entry capacity and Annual NTS exit (flat) capacity, such provisions relieve NGG NTS of its obligation to buy back capacity, whilst users (shippers) remain liable for the full value of the capacity charges related to their capacity holdings at the affected Aggregate System Entry Point (ASEP) or NTS exit point. Currently there is no requirement for NGG NTS to notify a shipper unless they are an affected party within the FM notice.

The modification proposal

UNC 262 seeks to address the impact on users at either an ASEP or an NTS exit point on occasions when NGG calls a FM which affects users' capacity rights. The modification proposes to introduce a rebate, whereby shippers who hold capacity which is affected by a FM event will receive a rebate for the capacity which cannot be provided, in order to offset the capacity charges they are required to pay for that affected capacity. However, this does not change NGG's overall revenue entitlement in any way. The revenue that would have been recovered from those shippers for the capacity that is subject to FM will be recovered from the generality of shippers via higher commodity charges.

This modification proposal only applies to quarterly and monthly entry capacity (QSEC[2], AMSEC[3], RMTTSEC[4]) or Annual Exit (Flat) capacity.

Where more than one user holds capacity at a NTS entry/exit point, then the quantity of capacity affected by the FM notice will be pro-rated among all holders of capacity at that entry/exit point. The value of the FM rebate will be calculated using the weighted average price of each user's registered capacity holdings at that system entry/exit point.

An FM rebate would be mapped to one of the following licence terms;

- Standard Special Condition C8B 2(a); Definition of $TORCOM_t$[5] - TO revenue other than that collected through capacity charges

[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] Quarterly System Entry Capacity auction
[3] Annual Monthly System Entry Capacity auction
[4] Rolling Monthly Trade and Transfer System Entry Capacity auction
[5] This term is defined in the licence and is one of the components which determines transportation owner revenue in any formula year

- Standard Special Condition C8C 2(a); Definition of $RCOM_t$[6] - SO revenue other than that collected through capacity and other Licence defined charges

An FM rebate in regard to capacity sales, which represent TO revenue, would be treated as TO revenue; this would result in increased TO Entry Commodity Charges and/or TO Exit charges. An FM rebate in regard to capacity sales, which represent SO revenue, would be treated as SO revenue; this would result in increased SO Commodity Charges (Entry & Exit).

The proposal introduces a Force Majeure Option Agreement which NGG NTS will exercise on behalf of users. This is the mechanism which will state the amount of firm capacity which a shipper needs to surrender and which forms the basis of the calculation of the rebate amount. NGG will update its systems within two business days of a FM notice being issued with details of the FM Option Agreement. The FM Rebate will be calculated monthly and invoiced via an ad-hoc invoice issued in the same month, on a reasonable endeavours basis.

The proposal also allows NGG NTS to consider the use of a Force Majeure Forward Agreement where it deems it to be appropriate and has agreed to do so with the affected users at the NTS system point. For the purposes of this modification proposal a Force Majeure Forward Agreement will be a capacity management agreement that NGG NTS will enact on its system on behalf of users.

Under the proposal, on occasions when NGG calls a FM event, NGG will be required to notify all users that an instance of FM has occurred; currently there is no such requirement and only those users affected are notified in the event that NGG declare FM.

UNC Panel[7] recommendation

At the Modification Panel meeting held on 17 September 2009, the majority of Panel members considered that the reallocation of the FM risk from affected shippers to the community as a whole would facilitate competition between shippers. Some Panel members commented that implementation of UNC262 could incentivise NGG to declare FM more readily, thereby driving inappropriate behaviour. Of the eight Voting Members present, capable of casting nine votes, eight votes were cast in favour of implementing this UNC262. Therefore the Panel recommended implementation of this proposal.

The Authority's decision

The Authority has considered the issues raised by the modification proposal and the Final Modification Report (FMR) dated 21 October 2009. 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[8].

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[6] This term is defined in the licence and is one of the components which determines system operation revenue in any formula year

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

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

The Authority has concluded that implementation of the modification proposal will not better facilitate the achievement of the relevant objectives of the UNC[9].

Detailed reasons for the Authority's decision

The proposer submits that the relevant objectives set out in sub-paragraphs (a) and (d) of Standard Special Condition A11.1 would be better facilitated by the proposed modification. We agree that these are the appropriate relevant objectives to consider and set out our views on these objectives below.

Standard Special Condition A11.1 (a): the efficient and economic operation of the pipe-line system to which this licence relates;

Overall we do not consider that the proposal better facilitates achievement of this objective.

The proposer and supporters of the proposal consider that the widespread release of information relating to a FM notice would have positive benefits in allowing shippers to rebalance their portfolios and ensure that available capacity elsewhere is fully utilised. Any such actions could help to mitigate the effects of the shortfall in capacity caused by the FM event and this would help to improve security of supply. We agree that NGG should be required to inform the wider community about instances of FM, such that the market can respond accordingly, and we also consider that NGG should keep the community (and not just those directly affected by the FM notice) regularly advised of its actions to overcome the FM and resume performance of its relevant obligations. This transparency may better facilitate the achievement of this relevant objective.

However, we consider that this proposal will affect the incentives on parties in the event of a FM as it transfers the risks (and associated costs) for the affected capacity to consumers, even though consumers do not have the ability to manage or influence the outcome. Whereas there may be a case for saying that for a true FM event it could be appropriate for the costs to be underwritten by the generality of consumers, implementation of this proposal would weaken the incentive on affected shippers to challenge the legitimacy of a FM notice. Therefore, there is a risk that implementation may serve to lower the hurdle applied by NGG in declaring an FM event and could lead to more frequent use of the FM mechanism and a slower resolution of FM events in circumstances when a FM has been declared. If such behaviour were to be seen, it would also serve to weaken the buyback incentive on NGG. This runs contrary to the achievement of this relevant objective.

Further, we note that the proposal has been written under the assumption that the FM is valid; a respondent has raised the concern that in instances where the FM is successfully challenged, the automatic triggering of the Force Majeure Option Agreement denies the affected shipper the opportunity to submit buy-back prices to NGG. It seems to us that the proposal is underdeveloped in this regard.

Standard Special Condition A11.1 (d): so far as is consistent with subparagraphs (a) to (c) the securing of effective competition:
(i) between relevant shippers;
(ii) between relevant suppliers; and/or

[9] As set out in Standard Special Condition A11(1) of the Gas Transporters Licence, see: http://epr.ofgem.gov.uk/document_fetch.php?documentid=6547

(iii) between DN operators (who have entered into transportation arrangements with other relevant gas transporters) and relevant shippers;

This modification was brought forward as a result of shippers feeling aggrieved that under conditions of FM, they have to continue paying charges for capacity which they cannot use, yet NGG is cleared of its obligations in relation to the provision of that capacity. NGG has indicated that shippers do not have the option of declaring FM in the same circumstances, as they are not deemed to be an "Affected Party" in relation to capacity within the terms of the current Force Majeure provisions in the UNC.

The modification proposes to rebate the shippers with capacity affected by the FM, and then recover the capacity charges due in respect of this through increased commodity charges across all shippers, not just those affected by the FM. The majority of respondents considered this to be a fairer way of dealing with the uncertainty associated with the imposition of an FM notice, such that individual shippers would not be disproportionately disadvantaged in such circumstances. This equalisation was seen to facilitate competition between shippers and therefore facilitate objective (d) as detailed above. Most respondents also considered that the abatement of such risks would make the GB regime more attractive to developers when looking to invest in the gas transmission network. We agree that removal of this risk could have the potential to reduce barriers to entry and lead to greater investment.

However, we consider that facilitating redistribution of costs by this means carries some negative aspects. There is the potential that efficient operators may have some form of insurance to cover capacity risks of the nature they are exposed to through FM, and as such, this will be reflected through a risk premium already incorporated in their pricing. In such circumstances, the socialisation of these costs through smearing across all shippers may not have an impact on overall market competitiveness. Also, in instances where the affected revenues are mapped to the SO revenue term, this redistribution represents a cross-subsidy between entry and exit shippers, which may not be appropriate.

Proponents of the proposal claim that any implementation cost effects for consumers are relatively small and are more than offset by the gains to consumers through the beneficial effects on gas price by instilling confidence in long-term investment by developers. We agree that this effect might make the GB system a more attractive investment for developers, but this is also the case with a subsidy; it may not increase competitiveness between shippers, and so we remain unconvinced that overall this objective is better facilitated by the implementation of the modification.

Conclusion

In summary, while we agree that some parts of this proposal have merit, overall we do not consider that it better facilitates achievement of the relevant objectives. When considered in conjunction with our wider statutory duties of protecting consumers, both present and future, we believe that the in the absence of an effective challenge mechanism for FM notices, transfer of FM risk in the manner proposed would not be in consumers' best interests. Accordingly, the Authority does not approve implementation of UNC262.

Further considerations

We agree that the sentiment that those shippers who are willing to commit to long term capacity should not be unduly penalised through no fault of their own, but we consider that it is the resolution of this issue that needs to be addressed, rather than simply redistributing the costs onto other market participants. We also consider it important that there is an effective shipper challenge to FM notices issued by NGG, to ensure a balanced approach to the governance of these commercial arrangements. Finally, we consider that the lack of transparency surrounding the notification of FM events at the moment is of potential detriment to the market and should be reviewed. We would encourage the industry to bring forward an appropriate modification to deal with this transparency issue in due course.

We consider that in the event of a capacity related FM, the parties whose capacity holdings are affected by the notice should be able to seek relief from the associated charges for at least part of the notice period. The current lack of risk on NGG revenues seems inappropriate, in that it does nothing to force them to resolve the issue around the FM.

We consider the following to be central to any consideration of a change to the current FM arrangements: whether the current UNC terms are in line with general FM commercial terms (if not, we believe that the FM sections of the UNC could be amended to give effect to such changes, which would bring about a more equitable environment, without transgressing the principles of established FM case law and commercial practice); and, how charges which have been affected by a FM event could be rebated to affected shippers.

We would expect to explore how NGG could be incentivised around FM costs as part of the next Transmission Price Control Review. We recognise that this will require significant input from all parties, and would urge the work to consider the issues to start as soon as possible to mitigate potential losses from shippers currently affected by FM notices.

Stuart Cook
Director, Transmission

Signed on behalf of the Authority and authorised for that purpose.