Modification proposal:	**Uniform Network Code (UNC) 349: Introduction of a Force Majeure Capacity Management Arrangement**		
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:	16 August 2011	Implementation Date:	To be confirmed by the Joint Office

Background to the modification proposal

Under the current UNC arrangements, when National Grid Gas (NGG) issues a Force Majeure (FM) notice, it no longer has to make payment for any failure to meet its obligations. For instance, declaring FM in relation to NTS (National Transmission System) Entry Capacity relieves NGG NTS of its obligation to buy back capacity (hereafter referred to simply as 'buy-back') where it is unable to meet its obligations. However, entry users (shippers) remain liable for the full value of their capacity holdings at the affected Aggregate System Entry Point (ASEP) or NTS exit point throughout the period of the FM. In contrast, user liability for the full value of exit capacity holdings affected by FM ceases after 7 days.

UNC modification 262[3] sought to rebate charges on both entry capacity and exit capacity affected by the FM. We agreed with the proposer (NGG) that those shippers who are willing to commit to long term capacity should not be unduly penalised through no fault of their own. However, we rejected UNC262 as it would have smeared the cost of the rebate across all users without exposing NGG to any costs. We saw this as transferring an unduly high proportion of the risks (and associated costs) for the affected capacity to consumers.

Our decision on UNC 262 indicated that we sought a modification which: addressed the penalisation of users affected by FM but did not simply redistribute costs to other participants; allowed for effective challenge to the FM; and, ensured transparency around FM events.

The modification proposal

UNC349 has been raised by BG Group. It proposes that when an FM is notified to the industry, a FM Capacity Management Arrangement (FMCMA) is put in place for the duration of the FM. This FMCMA effectively rebates capacity charges back to affected shippers, and allows NGG to exercise an option to curtail shipper flows to the FM level without exposing itself to buy-back. The proposal will only cover treatment of quarterly or monthly entry capacity allocated through QSEC, AMSEC, or RMTTSEC[4] before the FM notification is issued.

[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] Uniform Network Code (UNC) 0262: Treatment of Capacity affected by Force Majeure (available at http://www.gasgovernance.co.uk/0262)
[4] Quarterly System Entry Capacity auction, Annual Monthly System Entry Capacity auction and Rolling Monthly Trade and Transfer System Entry Capacity auction respectively

The arrangements identify a FM Quantity (sold capacity minus surrendered capacity minus the FM adjusted baseline[5]) for an affected ASEP. On the date of the FM notice, where users in aggregate hold capacity that would entitle them to flow gas in excess of the level implied in the FM notice, then NGG will draw up one or more FM Option Arrangements (FMOA). These options, at NGG's discretion, can be for a day(s), a month(s) or quarters(s). At any time while the FM notice is in place, NGG can choose to exercise the option at any level up to the FM Quantity, and on exercise of the option the user will be deemed to have surrendered that capacity. The exercise price of the option is zero in all circumstances.

Each user will receive a payment based on the product of the FMOA quantity[6] and option premium which will differ between shippers reflecting the price at which they purchased their capacity. This will be independent of whether or not the option is exercised. Therefore, it is in effect a full rebate of capacity charges. The option cost would be treated as a National Transmission System (NTS) entry capacity constraint cost and feed into NTS entry capacity Neutrality and Operational Entry Buy-back. Hence the rebated costs to FM affected shippers would be met on a shared basis ie, 50% from the generality of shippers and 50% from NGG.

The proposer believes that the proposal will better facilitate relevant objectives a), b) and d) of the UNC[7]:

UNC Panel[8] recommendation

The Joint Office received 13 responses to its consultation on Mod 349. Eleven respondents supported the implementation of the proposal and two did not.

At the Modification Panel meeting held on 16 December 2010, seven votes were cast in favour of implementing this Modification Proposal and three against. Therefore the Panel recommended by panel majority the 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 11 August 2011. 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[9]. The Authority has concluded that:

1. implementation of the modification proposal will better facilitate the achievement of the relevant objectives of the UNC; and
2. directing that the modification be made is consistent with the Authority's principal objective and statutory duties[10].

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[5] An FM notice identifies the amount of gas that NG is no longer able to flow at an ASEP (the FM amount). Subtracting this from the ASEP baseline gives a FM adjusted baseline.
[6] The FMOA quantity for each user will be determined based on their proportion of the registered Firm NTS capacity that they held at the time of the notification (excluding surrendered capacity).
[7] As set out in Standard Special Condition A11(1) of the Gas Transporters Licence, see: http://epr.ofgem.gov.uk/index.php?pk=folder590301
[8] The UNC Panel is established and constituted from time to time pursuant to and in accordance with the UNC Modification Rules
[9] UNC modification proposals, modification reports and representations can be viewed on the Joint Office of Gas Transporters website at www.gasgovernance.com
[10]The Authority's statutory duties are wider than matters which the Panel must take into consideration and are detailed mainly in the Gas Act 1986.

Reasons for the Authority's decision

We consider that UNC 349 will better facilitate the achievement of the UNC relevant objective (a). We remain neutral as to its effects on (b) and (d) as set out below:

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

The proposer considered that implementation of UNC349 would introduce additional certainty into the UNC that will enable optimisation of supply at an Entry Terminal under circumstances of FM affecting capacity rights. The proposal will require NGG to share the risk and cost that is currently borne by affected shippers and is likely to assist in reducing any perception that there is an incentive to call FM.

A respondent considered that the order in which NGG sought to resolve concurrent FMs would be influenced by the price that had been paid for capacity. However, we consider that the order in which NGG might look to resolve FM would also take into account the investment required to fix the FM. There are also other incentives on NGG to resolve FM events including licence obligations and reputational risks. The rebate of capacity charges should not be seen as precluding challenges based on the impact on commercial energy flows.

In our view, the sharing of risk and cost must provide an additional incentive on NGG to manage FM events effectively. In bearing half of the costs of the rebate, NGG would be incentivised to minimise the amount that they state that they are unable to flow and minimise the duration of the FM. We therefore agree with the proposer that this objective is better facilitated.

Standard Special Condition A11.1 (b): the co-ordinated, efficient and economic operation of the combined pipe-line system;

The proposer has argued that there is a benefit to removing a potential obstacle to the development of new and existing Entry Points for the entire network. We consider that objective (b) relates to the joint Transmission and Distribution Systems and any potential benefits arising from the proposer's point would serve to facilitate objective (a) above.

Standard Special Condition A11.1 (d): so far as is consistent with subparagraphs (a) to (c), secure effective competition between relevant users

The proposer argues that the proposal promotes greater equality in the treatment of FM and costs between the Transporter and shippers which will encourage effective competition and also make the UK regime more attractive to developers. We agree that this modification has benefits in mitigating the disproportionate effect of FM on affected shippers and that this would encourage developers.

However, those who are not in support of the modification have argued that there are undesirable competitive effects. We consider the most significant of these is the claim that there are cross subsidies that arise out of the proposed arrangements. These occur because the costs of the option product are shared between NGG and Industry (via SO commodity charges). In our decision on UNC 262, in the context of half of the capacity rebate costs being met by exit shippers, we stated that in instances where the affected revenues are wholly mapped to the SO revenue term, this redistribution may not be appropriate. However in this proposal NGG is exposed to a proportion of the costs, and a quarter of the costs are borne by exit shippers. It should be noted that this re-allocation of costs does not change the nature of the existing SO incentive in relation to constraint management costs, nor does it alter the relative distribution of costs under this mechanism. In our view, whilst this feature of the modification may not be ideal, the introduction of an additional constraint management term to the existing incentive means that the impact of the cost allocation associated with this proposal is significantly reduced (in comparison with the UNC 262 modification proposal).

One respondent supported the principle of socialisation of costs for FM events but only for events that have yet to occur. The same respondent suggested that where shippers' customers were on fixed or capped price supply arrangements then shippers would be unable to recover costs which result from this proposal. This argument is equally true for all other constraint management costs. We consider these distributional effects to be a reflection of commercial decisions taken by shippers and not a matter for Ofgem.

On balance, we consider that the modification is neutral in terms of its effects on competition. We believe that the re-allocation of a proportion of the costs among shippers, when judged against the benefits for individual shippers at an affected ASEP balances out to give a neutral outcome.

Other issues
We do not consider this to be a retrospective modification, though we note that it will have an impact on any existing FM event from the date of implementation.

There are also areas of the current regime such as the operational buy-back scheme where it has been accepted by Ofgem that users are exposed to uncertain costs. As ever, if parties think that the redistribution of costs arising from this proposal is inappropriate, they can bring forward further proposals to address any perceived defects.

For UNC Mod 262 we were concerned that the incentive for shippers to challenge an FM event is lowered where there is a rebate of capacity costs. We consider this concern to be less pressing in the current context, and we observe that no challenge to the Milford Haven FM has emerged. Additionally by exposing NGG to a proportion of the costs we believe that the proposal provides NGG with a direct incentive to minimise the impact of the FM on network users.

Conclusions
We consider that the proposal better facilitates the achievement of the relevant objectives. It meets the criteria established in our decision on UNC 262 in three ways:

- It provides less incentive to NGG to call FM, and incentivises NGG to minimise both the FM amount and its duration.
- The proposal also ensures that those users that have committed to long term capacity which is subsequently affected by an FM event are not penalised.
- Finally, the modification is transparent in notifying all users with data on the options that have been created and when they have been exercised.

Further considerations

Ofgem will monitor the implementation of the modification to ensure that it accords with NGG's duties and obligations under its licence. In our UNC Mod 262 decision we identified that there was a need to consider whether current FM terms are in line with general commercial FM terms, and whereas we believe that this modification is a step in the right direction, more work remains to be done. Several respondents also suggest that the current arrangements are flawed. We anticipate that RIIO-T1[11] will provide an opportunity to consider these and other issues, such as the current different treatment of FM in the entry and exit regimes.

Finally, in this particular instance there has been a considerable delay in the drafting of the legal text, and in correcting and amending errors in the text submitted. We would hope that NGG takes note of the lessons learnt from this process so that user generated proposals are progressed in a more timely manner going forward.

Decision notice

In accordance with Standard Special Condition A11 of the Gas Transporters Licence, the Authority hereby directs that modification proposal UNC 349: 'Introduction of a Force Majeure Capacity Management Arrangement' be made.

Hannah Nixon
Partner, Transmission

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

11 RIIO-Transmission Price Control Review 1 (RIIO-T1) is the price control review to be applied to the electricity and gas transmission network operators, following the TPCR4 rollover. This price control would be expected to run from 1 April 2013 and will be the first transmission price control review to reflect the new regulatory framework, RIIO, resulting from the RPI-X@20 review.