

Modification proposal:	<b>Uniform Network Code (UNC) 156 / 156A / 169 / 169A: Transfer and Trading of Capacity Between ASEPs (UNC156 / 156A / 169 / 169A)</b>		
Decision:	The Authority <sup>1</sup> directs that UNC169 be made and that UNC156, UNC156A and UNC169A should not be made <sup>2</sup>		
Target audience:	The Joint Office, Parties to the UNC and other interested parties		
Date of publication:	6 September 2007	Implementation Date:	7 September 2007

## Background to the modification proposal

In the 2002-2007 price control National Grid Gas NTS (NGG NTS) had an obligation to use all reasonable endeavours to offer for sale a baseline level of capacity at each Aggregate System Entry Point (ASEP). This provided certainty of the amounts of capacity available but did not allow for unsold capacity to be reallocated to where users value it most. Additionally, current arrangements allow a user to trade all or part of its National Transmission System (NTS) entry capacity rights with another user at the same ASEP, however, this does not allow for trades between different ASEPs.

As part of the Transmission Price Control Review (TPCR) 2007-2012 Ofgem has placed a new obligation on NGG NTS to facilitate the transfer of unsold entry capacity to meet demands for capacity elsewhere on the NTS, referred to as "transfers". Ofgem has also placed an obligation to facilitate the trade of sold capacity between ASEPs, referred to as "trades". This was to guard against the risk of capacity being 'sterilised' at an entry point where it is not needed and to facilitate access to available network capacity and prevent gas being unnecessarily stranded offshore.

There have been some previous modification proposals that dealt with the transfer and trade of entry capacity. On 8 May 2007 the Authority rejected proposal UNC138 (Transitional Arrangements for Entry Capacity Transfers to Sold Out ASEPs<sup>3</sup>) to introduce a mechanism whereby a shipper, holding NTS entry capacity rights at multiple ASEPs, could reallocate that capacity between different ASEPs in its portfolio. This decision was on the grounds that it did not further the objectives of efficient and economic operation of the NTS, efficient discharge of NGG NTS's licence conditions and securing effective competition.

On 12 June 2007 the Authority rejected proposals UNC150 (Introduction of the AMTSEC Auction<sup>4</sup>), UNC150A (Introduction of Unsold Entry Capacity Transfers<sup>5</sup>) and UNC151/UNC51A (Transfer of Sold Capacity between ASEPs<sup>6</sup>) to introduce separate transfer and trade mechanisms. This decision was on the grounds that they did not

<sup>1</sup> The terms 'the Authority', 'Ofgem' and 'we' are used interchangeably in this document. Ofgem is the Office of the Gas and Electricity Markets Authority.

<sup>2</sup> This document is notice of the reasons for this decision as required by section 38A of the Gas Act 1986.

<sup>3</sup> <http://www.gasgovernance.com/NR/rdonlyres/7C6E3EAD-08B0-4FFD-856B-6C1166D11054/16968/OfgemDecisionLetter.pdf>

<sup>4</sup> <http://www.gasgovernance.com/NR/rdonlyres/219A4091-B771-4BBB-A16E-E3355EE2F32D/17679/01500150AOfgemDecisionLetter.pdf>

<sup>5</sup> See footnote 4

<sup>6</sup> <http://www.gasgovernance.com/NR/rdonlyres/A27A4944-5214-4C79-B01D-AEE38305EEA1/17680/01510151AOfgemDecisionLetter.pdf>

further the objectives of efficient and economic operation of the NTS and securing of effective competition.

Ofgem has been presented with two new proposals on Transfer and Trade, UNC156 and UNC169, and each of these have attracted a variant proposal. These are discussed below.

### **The modification proposals**

#### **UNC156: Transfer and Trading of Capacity Between ASEPs**

NGG NTS proposes that the transfer of unsold capacity and trade of sold capacity between ASEPs for the period between October 2007 and March 2008 is undertaken in a single combined mechanism. This mechanism is based on a pay-as-bid auction and would be comprised of a number of stages and processes as follows:

- NGG NTS notifies users of which ASEPs capacity has nearly sold out and for which months
- Users notify NGG NTS when and which ASEPs they propose to make bids for capacity
- NGG NTS notifies users of information on the upper limits for entry capacity for the ASEPs and zones, inter zone exchange rates, unsold capacity and the merit order of ASEPs
- Users wishing to offer to trade capacity which they already hold, notify NGG NTS of the maximum capacity they are willing to surrender and at which ASEP
- NGG NTS invite users to make bids subject to the reserve prices in one auction
- Users make bids in the auction

Allocations are first made on a 'within zone' basis in order of highest bid price first (and on a time basis for equal priced bids). Capacity is relocated from 'donor' ASEPs according to the merit order sequence. Then for each ASEP in the merit order capacity is allocated first from the remaining unsold capacity and secondly from surrendered capacity. 'Within zone' allocations are done on the basis of a 1:1 exchange rate.

Following the 'within zone' allocation, if there are unsatisfied bids at certain ASEPs and there is still capacity available to be allocated, an 'out of zone' allocation takes place. Allocations are made on the basis of the highest bid price or translated bid price when the relocation of capacity is across zones (and on a time basis for equal price bids or translated bids). Capacity is transferred from 'donor' ASEPs in the same way as the 'within zone' process by application of the inter-zone exchange rate when the relocation of capacity is across zones.

The proposer considers that UNC156 will better facilitate the relevant objectives<sup>7</sup> of:

- The efficient and economic operation of the pipe-line system to which this licence relates
- The efficient discharge of the licensee's obligations under this licence
- The securing of effective competition between relevant shippers

#### **UNC156A: Transfer and Trading of Capacity Between ASEPs**

E.ON proposes UNC156A which is similar to UNC156 except that instead of one auction for all the transfer and trade of capacity between October 2007 and March 2008 there is:

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<sup>7</sup> as set out in Standard Special Condition A11 (1) (a) – (f) of the Gas Transporters Licence, see footnote 7

- One single round auction for the transfer and trade of capacity for October, which would be conducted on a much reduce time scale  
Another auction with two rounds of bidding for the transfer and trade of capacity between November 2007 and March 2008

E.ON proposed this as it considers that a number of auctions will allow for price discovery, improved transparency and greater flexibility. It considers that UNC156A will better facilitate the relevant objectives of:

The efficient and economic operation of the pipe-line system to which this licence relates

- The efficient discharge of the licensee's obligations under this licence
- The securing of effective competition between relevant shippers
- The provision of reasonable economic incentives for relevant suppliers to secure that the domestic customer supply security standards are satisfied as respects the availability of gas to their domestic customers

### **UNC169: Transfer and Trading of Capacity Between ASEPs**

E.ON proposes UNC169 which is essentially the same as UNC156A, however, there are a few main changes to make this more flexible and implementable; these are that:

There is only one auction with two rounds for entry capacity transfer and trade for November 2007 to March 2008

- Round one of the auction does not have to be held before 1 October 2007, and Contingency arrangements are included should the decision date not allow auctions and allocations to be made for any of the months from November 2007 to March 2008

E.ON proposed this to address concerns that the two auctions proposed in UNC156A may not be possible to implement due to time delays in implementing the necessary licence conditions and consulting on the supporting Entry Capacity Transfer and Trade Methodology Statement. It considers that UNC169 will better facilitate the relevant objectives of:

- The efficient and economic operation of the pipe-line system to which this licence relates
- The efficient discharge of the licensee's obligations under this licence
- The securing of effective competition between relevant shippers
- The provision of reasonable economic incentives for relevant suppliers to secure that the domestic customer supply security standards are satisfied as respects the availability of gas to their domestic customers

### **UNC169A: Transfer and Trading of Capacity Between ASEPs**

Scottish Power proposes UNC169A which is essentially the same as UNC169, with the exceptions that:

All available capacity is first allocated at the ASEP where it was originally made available. Allocations on an 'at the ASEP' basis are made at the bid price. This must be greater than or equal to the Weighted Average Price (WAP) paid at the 2007 Annual Monthly System Entry Capacity (AMSEC) auction for sold capacity or greater than or equal to the reserve price for unsold capacity.

- Once allocations made on an 'at the ASEP' basis then allocations made on 'within zone' and 'out of zone' basis as per UNC169. The allocation prices for the 'within zone' and 'out of zone' basis are also as per UNC169.

Scottish Power proposed this as consider that a problem with UNC156, UNC156A and UNC169 is that they allow for the transfer of capacity rights away from an ASEP when there is still unsatisfied demand there. It considers that UNC169A will better facilitate the relevant objectives of:

- The efficient and economic operation of the pipe-line system to which this licence relates
- The securing of effective competition (i) between relevant shippers; (ii) between relevant suppliers; and/or (iii) between DN operators and relevant shippers
- The provision of reasonable economic incentives for relevant suppliers to secure that the domestic customer supply security standards are satisfied as respects the availability of gas to their domestic customers

### **UNC Panel<sup>8</sup> recommendation**

At the modification panel meeting held on 2 August 2007, of the 8 voting members present, capable of casting 9 votes, 7 votes were in favour of implementing UNC156 and 8 votes were favour of implementing UNC156A. Furthermore, of the same voting parties 1 vote was in favour of implementing UNC156 in preference to UNC156A and 5 votes were in favour of implementing UNC156A in preference to UNC156. The panel determined that, of the two proposals, proposal UNC156A would better facilitate the achievement of the relevant objectives.

At the modification panel meeting held on 23 August 2007, of the 9 voting members present, capable of casting 10 votes, 9 votes were in favour of implementing UNC169 and 2 votes were favour of implementing UNC169A. The panel therefore recommended implementation of UNC169, but not UNC169A. Furthermore, of the same voting parties 9 votes were in favour of implementing UNC169 in preference to UNC169A and 0 votes were in favour of implementing UNC169A in preference to UNC169.

### **The Authority's decision**

The Authority has considered the issues raised by the modification proposal and the Final Modification Reports (FMR) dated 3 August 2007 and 23 August 2007. 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 FMRs<sup>9</sup>. The Authority has concluded that:

- 1. implementation of UNC169A would not better facilitate the relevant objectives of the UNC<sup>10</sup>;**
- 2. whereas in principle the implementation of UNC156A would better facilitate the relevant objectives of the UNC, the inclusion of specific dates means that the proposal can no longer be implemented due to the proposal being timed out;**
- 3. implementation of each of modification proposals UNC156 and UNC169 would better facilitate the achievement of the relevant objectives of the UNC; and**

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<sup>8</sup> The UNC Panel is established and constituted from time to time pursuant to and in accordance with the UNC Modification Rules

<sup>9</sup> UNC modification proposals, modification reports and representations can be viewed on the Joint Office of Gas Transporters website at [www.gasgovernance.com](http://www.gasgovernance.com)

<sup>10</sup> 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](http://epr.ofgem.gov.uk/document_fetch.php?documentid=6547)

**4. of these proposals, UNC169 best meets the Authority's principal objective and is consistent with the Authority's statutory duties<sup>11</sup>.**

**The Authority therefore directs that modification proposal UNC169 be implemented.**

**Reasons for the Authority's decision**

*The efficient and economic operation of the pipe-line system to which this licence relates*

One respondent was concerned that UNC156/156A has the potential to limit the amount of capacity available in the short term auctions creating scarcity at certain ASEPs. Another concern was the risk, identified by NGG NTS, of capacity from Theddlethorpe being transferred to Teesside, which may ultimately decide not to flow, thereby effectively leaving gas stranded at Theddlethorpe.

Ofgem's view is that UNC156/156A/169 would result in capacity being allocated to where users value it most. If there is the perception of 'scarcity' at certain ASEPs then we would expect this to be reflected in the price of capacity. Furthermore, if after the auctions the value of the capacity at that ASEP increases to a user then it can investigate the possibility of bilateral trades to acquire the capacity it requires.

One respondent questioned whether sold capacity would be surrendered as users would be doing this before knowing what price they would receive for it.

We recognise that potentially this could result in fewer capacity trades, however, at least until enduring arrangements have been developed, we consider that the use of a reserve price should go some way to mitigating this.

Some respondents thought that UNC156/156A/169 would reduce the extent to which sterilised capacity exists. We consider that the implementation of capacity transfer and trade should indeed reduce the risk of sterilised capacity in the network, which would be directly in consumers' interests.

Some respondents favoured the 1:1 exchange rate within zone as they consider this minimises capacity degradation. It was also commented that the use of an ex-ante rate is simple, transparent and reduces the need for costly and time consuming calculations which should reduce delays in the process.

Ofgem agrees in that UNC156/156A/169 would result in unsold (sold) capacity being allocated (reallocated) to other ASEPs where it is valued more. This would reduce the possibility of capacity at a particular ASEP, where it is not required being effectively sterilised. We also welcome the simplicity, transparency and predictability of using ex-ante exchange rates.

A number of respondents noted that the greater visibility in prices from two rounds of pay-as-bid auctions would lead to a more efficient outcome. It was thought that two rounds allowed for capacity to be allocated to those who value it most.

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<sup>11</sup>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.

Ofgem agrees that the use of multiple auction rounds in UNC156A/169/169A would allow for greater visibility of prices and price discovery. This would facilitate users in finding the market price for capacity which would be the most efficient price at which to allocate capacity.

One concern raised by respondents with UNC169A was that it could reopen previously closed auctions, thus allowing ex-post distortions to the view of where users value capacity most. Furthermore it allows users to obtain capacity at a price not related to current market value. Respondents to UNC169A considered that under existing arrangements the UNC already facilitates bilateral trading of capacity at the same ASEP. One respondent commented that UNC156/156A/169 would allow users to be able to secure capacity at the ASEP where it originated by paying the market price.

Ofgem agrees that there is a risk with UNC169A in that capacity would be sold on preferential terms at the ASEP where it was originally made available rather than being transferred or traded to another ASEP where it is more highly valued. This would not be the most efficient means of allocating capacity.

One respondent noted that the Zonal Allocation Maximum (ZAM) figure is very important as a low figure could reduce the amount of transfers and trades. It urged Ofgem to monitor and audit, if appropriate, the calculation of these figures. Ofgem agrees that in order to enable an economic and efficient operation of the network, by reducing the risk of sterilised capacity, it is important that the ZAM (and NAM) figures are determined in an appropriate manner. However, this will form part of the entry capacity transfer and trade methodology.

*So far is consistent with sub-paragraphs (a) and (b), the efficient discharge of the licensee's obligations under this licence*

A number of respondents considered that UNC156/156A/169 would ensure that NGG NTS meets its new licence conditions to facilitate transfer and trade.

Ofgem agrees that UNC156/169 would better facilitate the efficient discharge of NGG NTS's licence obligations as these aid facilitation of NGG NTS's new licence conditions, Special Condition C8D(11) and C8D(12), which were given effect on 5 September 2007. UNC156A would no longer do so as due to the inclusion of specific dates in the process, it is no longer possible to implement this proposal in the manner envisaged at the time it was originated. However, to fully meet its licence obligations NGG NTS would also need to have an appropriate entry capacity transfer and trade methodology in place.

*So far is consistent with sub-paragraphs (a) to (c) the securing of effective competition (i) between relevant shippers; (ii) between relevant suppliers; and/or (iii) between DN operators*

One respondent thought that use of a pay-as-bid auction in UNC156/156A promoted the securing of effective competition between shippers. Another argued that a zone based capacity transfer process increases the potential for shippers to compete for capacity across ASEPs and so enables more efficient delivery of lowest cost gas supplies. It was also noted that the proposals do not provide an advantage to one particular type of user.

Others noted that the use of two rounds of pay-as-bid auctions may lead to added complexity but that this would be outweighed by greater flexibility as it allows shippers the opportunity to observe bidding behaviour and revise strategies, thereby allowing for

price discovery which should promote competition between shippers. It was also thought that two rounds may increase participation and lead to greater diversity of supplies.

Ofgem agrees that UNC156/156A/169 would not offer one particular group any type of advantage in securing entry capacity. Additionally, a pay-as-bid auction should allow shippers to compete for the capacity available on the basis of price.

There were a number of concerns raised with UNC169A as to how it could frustrate competition. Firstly, it was noted that UNC169A gives preferential rights to some users to obtain capacity in advance of other users at a price not fully reflective of market conditions. Users are only in competition with other users at that particular ASEP rather than the intra and inter zone competition faced by other users. Another concern was that UNC169A would reward an incumbent user who withheld bids in the AMSEC auction, resulting in a low clearing price, to secure capacity at the average auction price. One respondent also considered that UNC169A would lead to a loss for surrendering users who have paid above the weighted average.

We agree that competition would be frustrated by UNC169A as it would give preference to shippers who wish to secure capacity at an ASEP from which that capacity was originally made available and at a price which is not reflective of the value of the capacity. Also competition would be restricted by shippers only competing for capacity on an ASEP first basis which may have fewer interested users, before opening up the competition to a 'within' zone and 'out of zone' basis.

*So far is consistent with sub-paragraphs (a) to (e), the promotion of efficiency in the implementation and administration of the network code and/or the uniform network code*

UNC156A has a rigid timetable which cannot now be implemented. Ofgem considers therefore that this would not promote efficiency in implementing the UNC, unlike the other modification proposals which have more flexible timetables.

Overall, UNC156/169 would all better facilitate the relevant objectives of efficient and economic operation of the NTS, efficient discharge of NGG NTS's licence obligations, securing of effective competition and securing the security of supply standards for shippers. Therefore, these modification proposals would better facilitate the relevant objectives overall. The efficient and economic operation of the NTS would be furthered more by UNC169 as a result of the two auction rounds.

UNC169A is discriminatory in that it requires capacity to be made available for sale at the ASEP where it was originally made available before being offered elsewhere. This would create the potential for incumbent shippers at such an ASEP to be given preferential treatment which is contrary to promoting effective competition. This would outweigh any of the benefits it has in furthering the relevant objective of securing the security of supply standards for shippers.

Of the two modification proposals which better facilitate the relevant objectives, the objectives would be furthered most by UNC169. This is because the scope for price discovery in the multi-round auction better facilitates the efficient and economic operation of the NTS than UNC156. As such UNC169 should best allow the Authority to carry out its principal objective in respect of protecting the interests of consumers. However, there is still scope to facilitate these objectives better, for example, by finding ways in which to encourage users to surrender greater amounts of capacity.

## **Further work**

Ofgem notes that this proposal relates to the coming winter only, and is not the basis of an enduring solution for NGG NTS to comply with its licence obligations in relation to the transfer and trade of entry capacity. We would expect consideration of these issues to continue in industry workstreams and that it will be important to review the experience of the coming winter to inform participants on the appropriateness of both the processes and underlying methodology, and to identify scope for improvement in the light of this, such that a revised set of arrangements will be in place well before winter 2008/09.

## **Decision notice**

**In accordance with Standard Special Condition A11 of the Gas Transporters Licence, the Authority, hereby directs that modification proposal UNC169: *Transfer and Trading of Capacity Between ASEPs* be made.**

A handwritten signature in black ink, appearing to read 'David Gray', with a long horizontal flourish extending to the right.

**David Gray**

**Managing Director of Networks**

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