Modification proposal:	**Uniform Network Code (UNC) 0285: "Use it or lose it" (UIOLI) Interruptible Capacity only to be released when there is at most 10% unsold firm entry capacity (UNC285)**		
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:	6 August 2010	Implementation Date:	N/A

Background to the modification proposal

Gas users wanting to bring gas onto the National Transmission System (NTS) have to purchase the appropriate volume of NTS entry capacity from National Grid Gas (NGG). Entry capacity is sold through a series of auctions spanning a range of time periods, from quarterly blocks up to 17 years ahead, right down to within-day sales.

NGG recovers the entry portion of its Transmission Owner (TO) allowed revenue through TO entry capacity and commodity charges. NGG receives TO revenue for entry capacity through the entry capacity auctions (except from within-day sales of NTS entry capacity, which are counted as System Operator (SO) revenue); the commodity element of revenue is derived from a volume-based charge which seeks to ensure that NGG achieves its TO allowed revenue, should there be a shortfall in the capacity revenue (relative to the TO allowed revenue).

The auctions have a reserve price which bids must equal or exceed in order to be allocated capacity. This reserve price is calculated by application of the gas transmission transportation charging methodology, and is based on the Long Run Marginal Cost (LRMC) at each entry point. The reserve price for a day's worth of NTS entry capacity is equal to 1/365th of the annuitised and adjusted[2] LRMC.

NGG offers discounts at auctions for daily firm entry capacity products, as follows:
- Day ahead auction: 33.3% discount on the reserve price
- Within-day auction: 100% discount on the reserve price i.e. a zero reserve price

At the auctions for daily interruptible entry capacity the reserve price is also set at zero. Users pay the price at which capacity is allocated for all auctions of NTS entry capacity; the price is not adjusted for inflation if bought in previous years.

In recent years, the commodity element of the TO revenue recovered by NGG has been growing, such that it currently constitutes the majority portion of the recovered revenue. Some users have expressed concern about the level and volatility of the commodity charge. NGG instigated a review of the entry charging arrangements to see if an alternative charging scheme which would address these concerns could be devised[3].

[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] These include adjustments so that a 50:50 split between entry and exit charges is maintained and that a minimum reserve price of 0.0001 p/kWh/day is applied to avoid negative reserve prices.
[3] See 'Discussion report: Modification Proposal to the Gas Transmission Transportation Charging Methodology & Associated UNC and Licence Issues, NTS GCD 08R: NTS Entry Charging Review' dated 15 March 2010 & 'Review Group Terms of Reference' both published on NGG's website, www.nationalgrid.com

The review group identified three key sources for low auction revenues, namely:

- Price paid: resulting from the reserve price discounts for daily capacity.
- Model changes: the Transportation model replaced the previous network model (Transcost) in 2007[4]. Prices based on Transcost were generally lower than those set via the Transportation model. As capacity can be bought up to 17 years in advance at auctions the lower prices set via Transcost will be important for a number of years.
- Peak amount of entry capacity procured: NGG noted that if entry capacity was procured at prevailing reserve prices at the forecast level of supply published in the Ten Year Statement (TYS)[5] then NGG would over-recover its TO allowed revenue. However, users do not book NTS entry capacity up to this level ahead of the gas day, i.e. before the reserve price is set at zero.

The review group developed a number of proposals and submitted these to Ofgem for decision. These tried to address the low auction revenues and high TO commodity charge by limiting the availability of discounted entry capacity. The main proposal to come out of the review was GCM19[6] (which requires the facilitating UNC modification proposal UNC284[7]). GCM19 proposed removing the discounts on the reserve price for the daily NTS entry capacity auctions (both day-ahead and within-day) such that the reserve price for daily NTS entry capacity auctions would be equal to the reserve price in the monthly entry capacity auctions. It was considered that GCM19 would limit the availability of discounted firm capacity. However, the review group noted that there would still be discounted interruptible capacity made available through the Use-It-Or-Lose-It ('UIOLI') mechanism[8] and that without further action, this may undermine the aim of the review group to reduce the TO commodity charge level and volatility.

The modification proposal

UNC285 proposes that NGG should only release UIOLI capacity at an entry point in situations where there is at most 10 per cent of entry capacity remaining unsold following the rolling monthly auctions (and so prior to the day-ahead auctions). Specifically, UIOLI will only be released when the unsold ratio is less than or equal to 10 per cent, where the unsold ratio is defined as:

- A/(B+C), or
- Zero, where (B+C) equals zero i.e. at new entry points where no incremental entry capacity has been triggered.

Where:
A = unsold entry capacity
B = baseline entry capacity
C = incremental obligated entry capacity

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[4] See Ofgem decision on GCM01 'Alternative methodologies for determination of NTS entry and exit capacity prices', which was published on Ofgem's website www.ofgem.gov.uk on 24 April 2007 with reference number 94/07. GCM01 implemented the Transportation model with effect from 1 October 2007.
[5] The Ten Year Statement (TYS) is published by NGG annually. It sets out the forecast of NTS usage and likely developments on the NTS.
[6] See 'Conclusions report to the Authority: Modification Proposal to the Gas Transmission Transportation Charging Methodology – NTS GCM 19R: Removal of NTS Daily Entry Capacity Reserve Price Discounts' published on NGG's website, www.nationalgrid.com
[7] See Final Modification Report (FMR) 'Removal of the Zero Auction Reserve Price for Within-day Daily NTS Entry Capacity (WDDSEC): Modification reference Number 0284' published on the Joint Office website www.gasgovernance.co.uk on 24 May 2010.
[8] NGG is required to release capacity that has been sold but expected not to be used as an interruptible product – this mechanism is called Use-It-Or-Lose-It (UIOLI). The actual amount of UIOLI capacity that NGG must release is the average unused capacity (firm capacity sold minus the proportion of that capacity which is used to flow gas) over the previous 30 days. This is released at the day-ahead stage.

The proposal stresses that there would be no change in the ability of NGG to release discretionary interruptible entry capacity additional to the UNC required UIOLI amount. The reserve price for daily interruptible capacity would remain at zero.

The proposer considered that UNC285 would better facilitate the following UNC relevant objectives[9]:

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

No changes to xoserve's systems or processes were identified as a result of UNC285 and so it is not presented as a User Pays proposal.

UNC Panel[10] recommendation

At the modification panel meeting held on 20 May 2010, of the nine voting members present, capable of casting ten votes, seven votes were cast in favour of implementing UNC285. Therefore the panel recommended implementing UNC285.

Impact assessment

On 24 June 2010 Ofgem published its impact assessment[11] on the suite of proposals. We received twelve responses[12], of which two were confidential. Six respondents, in general, supported implementation of the proposals (including UNC285) and six did not support their implementation.

A detailed summary of the responses, which tended to focus on GCM19, are included as an appendix to the Ofgem decision on GCM19[13]. However, we capture some of the specific comments relevant to UNC285 under the heading 'Reasons for the Authority's decision'.

The Authority's decision

The Authority has considered the issues raised by the modification proposal and the Final Modification Report (FMR) dated 29 May 2010. 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[14] and responses to our impact assessment.

The Authority has concluded that implementation of the modification proposal will not better facilitate the achievement of the relevant objectives of the UNC[15].

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[9] As set out in Standard Special Condition A11(1)(a) to (f) of the NGG's gas transporter licence for the NTS
[10] The UNC Panel is established and constituted from time to time pursuant to and in accordance with the UNC Modification Rules.
[11] See 'Review of NTS entry charge setting arrangements – Impact assessment', which was published on Ofgem's website www.ofgem.gov.uk on 24 June 2010, with reference number 77/10.
[12] The non-confidential responses can be found under 'Review of NTS entry charge setting arrangements – Impact assessment', which was published on Ofgem's website www.ofgem.gov.uk on 24 June 2010, with reference number 77/10.
[13] See the Authority decision 'Modification Proposal NTS GCM 19 "Removal of NTS Daily Entry Capacity Reserve Price Discounts"' published on Ofgem's website www.ofgem.gov.uk on 2 August 2010.
[14] UNC modification proposals, modification reports and representations can be viewed on the Joint Office of Gas Transporters website at www.gasgovernance.com
[15] As set out in Standard Special Condition A11(1) of the Gas Transporters Licence, see:

Reasons for the Authority's decision

Our overall assessment of UNC285 is that as a stand-alone proposal, it only serves to artificially restrict the capacity options for shippers without offsetting this with substantive benefits. Therefore, we do not consider that it better facilitates the achievement of the relevant objectives. We expand further on this view below.

Standard Special Condition A11(1)(a): the efficient and economic operation of the pipeline system to which the NGG NTS licence relates

Respondents in favour of implementing this proposal considered that implementation of UNC285 in combination with GCM19 would encourage more long-term bookings, resulting in more efficient planning of the NTS. However, others noted that if UNC285 was implemented on its own, there would still be firm entry capacity at zero reserve price made available within-day.

As the Authority has already vetoed implementation of GCM19 we do not consider that implementation of UNC285 on its own would encourage more long term booking of capacity. In Ofgem's view, restricting the release of interruptible capacity at the day-ahead stage would not cause users to purchase more capacity in the long-term auctions, because there would still be firm capacity available at zero reserve price within-day. Therefore, implementation would only serve to restrict the efficient allocation of capacity and would act against the facilitation of this relevant objective.

Some respondents were concerned that implementing UNC285 would result in situations where no entry capacity was available within-day, if sales at the rolling monthly entry capacity auctions were insufficient to trigger the release of UIOLI capacity but then entry capacity sold out at the day-ahead stage.

Our analysis presented in the impact assessment indicated that the likelihood of this scenario was low. However, the possibility of such an occurrence further underlines our view that this would be an inefficient use of existing unused entry capacity and would not be compatible with this objective.

Standard Special Condition A11(1)(c): so far as is consistent with sub-paragraphs (a) and (b), the efficient discharge of the licensee's obligations under the licence

Some respondents were concerned that the status quo gives undue preference to users at existing entry points as users at new entry points do not have access to UIOLI interruptible entry capacity until the contractual delivery date. They argued that UNC285 would reduce the occasions on which UIOLI was released and so reduce instances of this occurring. Ofgem and other respondents disagree as this differential treatment is based on relevant differences between new and existing entry points. Namely, that at new entry points NGG's obligations to provide capacity are either zero or are at the end of the lead time period, and interruptible capacity is not available until physical capacity is available. Therefore when physical capacity is made available at the contract delivery date the UIOLI mechanism then applies allowing users access to interruptible from that point forward.

Standard Special Condition A11(1)(d): so far as is consistent with sub-paragraphs (a) to (c), the securing of effective competition:

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http://epr.ofgem.gov.uk/document_fetch.php?documentid=6547

i. *Between relevant shippers;*
ii. *Between relevant suppliers; and/or*
iii. *Between GDN operators (who have entered into transportation arrangements with other relevant gas transporters) and relevant shippers*

Some respondents thought that UNC285, by limiting the release of UIOLI interruptible entry capacity at zero reserve price to when firm entry capacity is close to selling out, would encourage greater secondary trading.

Ofgem considers that in the limited instances where less than 90 per cent of entry capacity sells out after the rolling monthly entry auction but firm entry capacity sells out at the day-ahead entry auction, there may be more potential for secondary trading, though this would be an artificial stimulation of the secondary market. However, we noted above that this scenario is likely to be rare and so the benefits to competition very limited.

Summary

Overall Ofgem considers that, in the absence of GCM19 which was vetoed by the Authority[16], UNC285 does not achieve the review group aim of reducing the level and volatility of the TO entry commodity charge. It imposes artificial restrictions on the availability of system capacity, which limits shipper flexibility and is not compatible with the economic and efficient operation of the system.

EU law

Some respondents considered the status quo may not be consistent with EU law. They argued that Ofgem's assessment of the status quo against EU legislation implied that the use of auctions (including that for interruptible capacity) overrides other EU requirements such as tariffs being cost reflective and avoiding cross subsidies. Others considered that the proposal is inconsistent with EU law in limiting access to interruptible NTS entry capacity products.

Respondents also disagreed as to whether the status quo complies with the EU requirement for the price of interruptible to reflect the probability of interruption. Some argued that the interruptible reserve price did not have an explicit component which factored in the likelihood of interruption whilst others considered that the bid price encompasses the likelihood of interruption.

The current applicable EU regulations that must be complied with are set out in EU Regulation (EC) No 1775/2005[17]. This will be repealed by Regulation (EC) No 715/2009[18] which applies from 3 March 2011. We note that Article 3(1) of Regulation EC No 1775/2005 places a number of requirements on tariffs, or their methodologies, applied by transmission system operators including reflecting actual costs, avoiding cross subsidies, being transparent, etc. However, this same article also allows for tariffs to be determined through market based arrangements such as auctions. The UNC and charging methodology objectives aim to recreate competitive market conditions to facilitate

[16] See the Authority decision 'Modification Proposal NTS GCM 19 "Removal of NTS Daily Entry Capacity Reserve Price Discounts"' published on Ofgem's website www.ofgem.gov.uk on 2 August 2010.
[17] See Regulation (EC) No 1775/2005 of the European Parliament and of the Council of 28 September 2005 on conditions for access to the natural gas transmission networks on www.eur-lex.europa.eu
[18] See Article 14(1)(b) of Regulation (EC) No 715/2009 of the European Parliament and of the Council of 13 July 2009 on conditions for access to the natural gas transmission networks and repealing Regulation (EC) No 1775/2005 on www.eur-lex.europa.eu

market clearing at pricing levels which do not reflect artificial constraints. We noted in our decision on GCM19[19] that setting a floor price equal to the Marginal Cost (MC) of providing capacity allows the market to determine the price of capacity and allocate it efficiently. We consider that the MC of providing interruptible capacity at the day-ahead stage to be relatively low and a zero reserve price to be an appropriate proxy which should allow the market to clear without artificial restrictions. We note that if holders of interruptible capacity decide to flow they will contribute to allowed revenues via commodity charges and therefore consider there to be no cross subsidies in the current arrangements for interruptible.

Ofgem notes that Article 4(2)(b) of Regulation EC No 1775/2005 requires that the price of interruptible capacity reflect the probability of interruption and that Article 3 allows for the use of market mechanisms such as auctions. We consider that where auctions are employed, users will factor a number of elements into reaching their decision on what price to bid, one of which is the likelihood of interruption.

On this basis Ofgem is satisfied that our decision is consistent with current obligations on NGG under EU law. NGG should ensure that it complies with any developments in this area to the extent that they are required to under EU law.

Stuart Cook
Senior Partner, Transmission & Governance
Signed on behalf of the Authority and authorised for that purpose.

[19] See footnote 16.