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| Modification proposal: | Uniform Network Code (UNC) 0333/0333A: Extending Update of the default System Marginal Buy Price and System Marginal Sell Price Modification (UNC333/333A) | | |
| Decision: | The Authority ¹ directs that UNC333A be made ² | | |
| Target audience: | The Joint Office, Parties to the UNC and other interested parties | | |
| Date of publication: | 13 April 2011 | Implementation Date: | To be confirmed by the Joint Office |

Background to the modification proposal

On 1 April 2001, Network Code Modification 0433 'Changes to system cash-out prices' introduced the default System Marginal Prices (SMPs). Default SMPs apply where National Grid (NG) has not taken a Market Balancing Action or where one or more Market Balancing Action is taken but the associated Balancing Action Offer Prices have not reached a sufficient level to set the System Marginal Buy or Sell Price.

Network Code Modification 0433 sought to encourage shippers to trade out of their own imbalances and to leave NG National Transmission System (NTS) as the residual gas balancer. The default SMPs for Network Code Modification 0433 were derived using the average price of a Standard Bundled Unit at the Hornsea Storage facility for the 2001 storage year.

In March 2010, Ofgem introduced Special Condition C27: Balancing Arrangements into NG's licence. This special condition required NG to use reasonable endeavours to introduce updated values of the default SMPs by 1 April 2011, in consultation with shippers and other interested parties. We considered that updated (and more cost reflective) default SMP values would encourage greater efficiency with respect to the decisions made by shippers and NG.

The modification proposals

Modification Proposals 0333/0333A (UNC333/333A) seek to:

- update the default SMPs with a number based on the operational costs incurred by NG when managing a system imbalance, with this cost being based on a methodology and updated yearly; and
- remove old UNC Section F text that should have been removed as part of the Network Code Modification 0433.³

The proposed methodology to assess NG's operational costs is based on the NTS compressor costs and the cost of the pipeline space (or 'the opportunity cost of the linepack flexibility, which is the market value of the available transport capacity').

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 Specifically, incorrect text is situated at the end of Section F 1.2.1. It is proposed that the following text is removed "and for the avoidance of doubt on a Day on which National Grid NTS takes no Market Balancing Action the System Marginal Buy Price and the System Marginal Sell Price shall be the System Average Price." This statement was in contrast to the nature of Network Code Modification 433, which proposed using default SMPs on a day on which National Grid NTS does not make a residual balancing trade.

The difference between UNC333 and UNC333A is that the proposed User Pays cost allocation arrangements to implement this change are different. Specifically, under:

- UNC333 – the cost of implementing this modification is recovered 100% from shippers; and
- UNC333A – the cost of implementing this modification is recovered 75% from transporters and 25% from shippers.

UNC Panel⁴ recommendation

On 24 February 2011, the UNC Panel (the Panel) met and voted as follows:

- by majority in favour of implementing Modification Proposal 0333; and
- unanimously in favour of implementing Modification Proposal 0333A.

Five Panel members expressed a preference between UNC333 and UNC333A (one preferred UNC333 and four preferred UNC333A).

The Authority's decision

The Authority has considered the issues raised by UNC333 and UNC333A and the Final Modification Report (FMR) dated 16 March 2011. The Authority has considered and taken into account the responses to the Joint Office's consultation on Modification Proposal 0333/0333A.⁵ The Authority has concluded that:

1. implementation of either UNC333 or UNC333A would better facilitate the achievement of the relevant objectives of the UNC compared to the status quo, but that overall, directing the implementation of 333A will more effectively further the relevant objectives⁶; and
2. directing that UNC333A be made is consistent with the Authority's principal objective and statutory duties.⁷

Reasons for the Authority's decision

We note the majority support at Panel for UNC333 and the unanimous support for UNC333A. We also note respondents' preference for UNC333A compared to UNC333.⁸ For the reasons set out below, the Authority considers that UNC333 and UNC333A will further the objectives of Standard Special Condition A11.1 of the Gas Transporters Licence more effectively than the current baseline. We consider that, all else being equal, either proposal would better facilitate relevant objectives (a), (c) and (d) of Standard Special Condition A11 of the Gas Transporter Licence to the same extent. However, as it would

⁴ The UNC Panel is established and constituted from time to time pursuant to and in accordance with the UNC Modification Rules.

⁵ UNC modification proposals, modification reports and representations can be viewed on the Joint Office of Gas Transporters website at www.gasgovernance.com.

⁶ 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.

⁷ 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.

⁸ The Joint Office received 10 responses to its consultation. Of the 10 responses received with respect to Modification Proposal 0333: one respondent supported it; two respondents offered qualified support for it; and seven respondents did not support it. Of the 10 responses received with respect to Modification Proposal 0333A: five respondents supported it; three respondents offered qualified support; one respondent did not support it; and one respondent provided comments. Of the 10 responses received by the Joint Office, nine indicated a preference for Modification 0333A.

be impractical to direct the implementation of both proposals, we have taken into account the separate decision on whether or not to accept the associated changes to the Agency Charging Statement. Based on the consideration of this issue, we have decided not to veto the ACS submission which reflects the intent of UNC333A.

Standard Special Condition A11.1 (a): the efficient and economic operation of the pipeline system

We consider that the implementation of both UNC333 and UNC333A would encourage shippers to make a more efficient choice between balancing on the day or investing in a 'flexibility' product. We consider that updating default SMPs will ensure that the costs associated with the options faced by shippers will be more cost reflective.

We consider that updated default SMPs – based on more accurate costs – will allow shippers to make better informed decisions on how best to balance their positions. This will further facilitate this objective.

While the Workgroup members could not quantify the potential effects of updated (and more cost reflective) default SMPs, NG estimated that had the imbalance in energy during 2009 been cashed out at the proposed default SMP price, there would have been a saving to shippers of around £1.2m on the prevailing default SMP price. Set against this, we note from the FMR that xoserve's Rough Order of Magnitude (ROM) estimates one-off implementation costs to be between £205–227k. We therefore consider that the potential benefits can reasonably be expected to outweigh the costs of this proposal within a short period of time.

We also consider that updating the default SMPs on an annual basis is prudent and will help facilitate the efficient and economic operation of the pipeline system. We consider that updating annually strikes the appropriate balance between ensuring cost reflective costs, ensuring regulatory certainty and minimising any additional regulatory burden. Xoserve do not consider that there will be any future costs in revising the default SMP, as this functionality will be provided as part of the implementation of either UNC333 or UNC333A.

Standard Special Condition A11.1 (c): the efficient discharge of the licensee's obligations under its licence

Both UNC333 and UNC333A demonstrate that NG has used reasonable endeavours to introduce updated values of the SMPs by 1 April 2011. It has done this in consultation with shippers and other interested parties as is required under Special Condition C27.

We consider that the methodology proposed in both UNC333 and UNC333A to derive the default SMPs is an improvement over the current approach. This holds notwithstanding the inclusion of the cost of pipeline space – a sunk or long term cost – in the methodology. We consider the inclusion of this type of cost in the methodology is an area that may warrant reconsideration at a later time.

We therefore consider that both UNC333 and UNC333A better meet this relevant objective.

Standard Special Condition A11.1 (d): the securing of effective competition between relevant shippers, suppliers and distribution network operators

We consider that by more accurately reflecting the cost of addressing imbalances within the default cashout price that UNC333 and UNC333A will better facilitate competition. Shippers will face a more cost reflective price for competing flexibility products and will be able to make balancing choices accordingly. By providing a more cost reflective default cashout price, and therefore ensuring that shippers face the costs they impose, implementation is expected to facilitate competition. Specifically, the imposition of costs that more accurately reflect actual costs will encourage shippers to improve their decision making on how best to balance through the various options available to them. Any subsequent efficiency gains may then be passed through to customers.

Agency Charging Statement

The only difference between UNC333 and UNC333A is their respective approach to User Pays funding arrangements, which is currently outside the UNC and not part of the formal modification, as represented by the legal text. We consider that, all else being equal, either proposal would better facilitate the objectives of the UNC to largely the same extent. However, as it would be impractical to direct the implementation of both proposals, we have taken into account the separate decision on whether or not to accept the associated changes to the Agency Charging Statement.⁹

We consider that seeking to recover 100% of the ongoing and implementation costs of this proposal from shippers fails to recognise the benefits that NG should expect to capture in its role as System Operator. However, we do not consider that these benefits to NG necessarily equate to 75% of the ongoing and implementation costs, and may be disproportionate to the efficiency benefits that may accrue due to shippers facing more cost reflective prices.

While we consider that the estimated implementation costs of £205–227k will be more than outweighed by the benefits of revising the SMP, we note that some respondents considered this was a high estimate for a relatively simple system change. We have no evidence on which to consider the validity of these concerns without a more detailed cost assessment and consider that the costs of procuring one would, in this instance, be disproportionate.

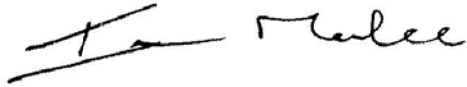
We consider that NG will be better placed than shippers to ensure the veracity of these costs throughout the development process. Subject to these costs being efficiently incurred and some evidence of where the benefits of the revised SMP fall in practice, we would be happy to reconsider NG's contribution, perhaps as part of any future logging up mechanism.

For these reasons, while we would have welcomed a fuller exploration of the funding options in line with the cost allocation matrix set out in the User Pays guidance document, we have decided not to veto the ACS submission which reflects the intent of UNC333A.

⁹ As set out in Standard Special Condition A15: 'Agency' of the Gas Transporters licence.

Decision notice

In accordance with Standard Special Condition A11 of the Gas Transporters Licence, the Authority, hereby directs that Modification Proposal UNC333A: '*Update of the default System Marginal Buy Price and System Marginal Sell Price*', be made.

A handwritten signature in black ink, appearing to read 'Ian Marlee', with a horizontal line drawn through the first few letters.

Ian Marlee
Partner, GB Markets

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