Modification proposal:	Uniform Network Code (UNC) 90: Revised DN Interruption Arrangements		
Decision:	The Authority[1] directs that proposal 90 be made[2]		
Target audience:	The Joint Office, Parties to the UNC and other interested parties		
Date of publication:	15 March 2007	Implementation Date:	1 April 2008

Background to the modification proposal

Interruptible capacity is used by the GDNs as a system management tool which, alongside linepack, pipeline reinforcement and incremental NTS offtake capacity, helps them manage their licence obligations (licence condition A9) to economically and efficiently meet the gas transportation needs of customers connected to their pipeline network.

The model for the current GDN interruption arrangements predates the sale by National Grid Distribution (NGD) of four of its eight distribution networks, and was introduced as part of the Network Code in March 1996, when Transco had sole responsibility for managing constraints across the transmission and distribution networks.

Ofgem's view that reform of GDN interruption arrangements is necessary, to address shortcomings with the existing regime, has been well documented since at least 2001. In 2005 the GDNs were given a licence obligation to use reasonable endeavours to review and develop proposals for the reform of the interruption arrangements within the distribution networks.

The weaknesses of the current arrangements and the principles Ofgem would like to see adopted for reform have been outlined in an initial thoughts consultation document published in May[3], and in a follow up consultation document including our draft impact assessment in October 2006[4]. Generally, we consider that much greater control of the amount of interruption purchased should rest with the GDNs, while customers should be able to offer terms for interruption that reflect the value they place on interruption rather than having to accept a uniform price. We have outlined that, in our view, this should help ensure that an efficient and economic amount of interruption is purchased, and that efficient trade-offs with alternative system operation tools, such as pipeline reinforcement and NTS offtake capacity, are made.

Following Ofgem's May consultation document, and consistent with their licence obligation to develop proposals for reform, in July 2006 National Grid Distribution raised UNC proposal 90. The proposal was raised with the support of each of the other GDNs and seeks to address the weaknesses of the existing interruption arrangements as set out in Ofgem's initial thoughts consultation document.

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.

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

3 Initial thoughts on the reform of interruption arrangements on gas distribution networks. May 2006

4 Reform of interruption arrangements on gas distribution networks – An update, October 2006.

The modification proposal

This proposal was raised by National Grid Distribution on July 7 2006 and has the expressed intention of reforming the interruption arrangements on the GDNs. To allow sufficient time for the content of the business rules to be agreed the proposal was considered by a development work group for three months and, following completion of the work group report, was voted to consultation at the UNC Mod Panel meeting on 19 October.

The proposal aims to improve upon the current interruption arrangements by introducing changes that will allow;

- GDNs to determine the quantity and location of interruption purchased
- Shippers, on behalf of customers, the flexibility to offer interruption on their preferred terms.

In so doing, the proposer considers that implementation of the Proposal would better facilitate the achievement of the relevant objectives of the UNC as set out in Standard Special Condition A11.1 of the gas transporters licence. The relevant objectives are:

- Efficient and economic operation of the pipeline system
- Effective competition between shippers
- Take account of developments in the transportation system

The key features of the Proposal are as follows:

- The existing Firm Exit Capacity booking arrangements will not be changed.

- The existing arrangements for requesting a switch from Interruptible to Firm status will continue to apply outside the annual process described in the modification proposal;

- Arrangements for requesting a switch from Firm to Interruptible status will only be available via the interruptible application process.

- Applications for interruptible capacity and management of interruption will continue on an individual supply point basis. This means that agreements to provide interruptible services would transfer between shippers if a supply point switched shipper.

- Applications for interruptible capacity will take place each year, at least three years ahead of the applicable Gas Year; for example, June 2008 for the Gas Year starting October 2011.

- GDNs will be permitted to tender for Interruptible rights in timescales shorter than three Gas Years, where, for instance, demand patterns change significantly.

- Through their shipper, customers will be able to apply for interruption contracts of up to five years length.

- Interruption payments made by GDNs to shippers will be based on an option and exercise scheme where the option fee will be an upfront payment for being available to be interrupted and the exercise fee will be payable for each day of interruption. The amount paid will be independent of transportation charges, and the pricing methodology used will be distinct from the transportation charging methodology. The interruption pricing methodology will either be set out as an appendix to each GDN's Transportation Charging Methodology or alternatively it will be set out as a stand alone document.

- Each GDN will publish its interruption requirements on a location by location basis and offer to purchase interruptible capacity for a range of maximum interruptible days, such as 5, 15, 30 and 45 days. Prices for interruptible rights would be dependent on the permitted number of days of interruption. Each number of days of interruption will attract an option/ exercise scheme dependent on the pricing methodology of the relevant GDN.

- Shippers will be able to apply for interruptible capacity in respect of all daily metered supply points.

- The GDN will be permitted to reject an application for interruptible capacity if the application was not required to maintain its required transportation capability.

- Once the regime has commenced new supply points that want to go firm will be allowed to go firm when the capacity becomes available. Otherwise, they will be allocated the minimum number of interruptible days that the GDN believes it must have available to continue to meet its obligations to other supply points. Providing firm capacity is available, once the scheme commences new supply points who want to be interruptible can only become interruptible via the interruption application process.

- In the context of interruption reform the period between the first interruption application process and the commencement of the new regime, three Gas Years, will be referred to as the transition period. New supply points that want to go firm within this period will be allowed to go firm where the capacity is available. Otherwise, they will be allocated the standard 45 day interruptible contract that other interruptible supply points will operate on until October 2010. New supply points that request to be interruptible within the transition period will also be awarded the standard 45 day interruptible contract.

UNC Panel[5] recommendation

At the Modification Panel meeting held on 21 December 2006, of the 10 Voting Members present, capable of casting 10 votes, 5 votes were cast in favour of implementing the Proposal. Therefore, the Panel did not recommend implementation of this Proposal. National Grid Distribution now seeks direction from the Authority as to whether or not the Proposal should be implemented.

Final Impact Assessment

In May 2006 Ofgem requested information on the potential costs and benefits of the proposed approaches as an input into an Impact Assessment (IA). In October 2006 Ofgem published a draft IA on interruption reform which took account of information

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

provided by the GDNs, Xoserve, shippers and customers[6]. In the draft IA Ofgem's analysis of the potential benefits of interruption reform suggested that plausible assumptions about investment efficiency would lead to the benefits of reform exceeding costs.

Following receipt of responses to our draft IA we have updated our cost benefit analysis and published our Final Impact Assessment on implementing modification proposal 90. Each of the GDNs have provided more detailed estimates for the costs of implementing reform, and although the information is still quite limited we have received more substantive costs submissions from customers. At an aggregate level, the additional cost submissions have increased the overall estimate of the cost of implementing interruption reform, but this additional data has not altered our view that the benefits of reform can reasonably be expected to exceed the costs.

In our draft IA we said that benefits of reform could potentially be realised both as a result of investment efficiencies achieved as a result of interruption reform providing better investment signals, and as a result of a number of qualitative benefits such as the distributional impact on customers, security of supply and the potential impact on the operation of the wholesale electricity market. We remain of the view that these benefits can be realised and combined can plausibly be expected to exceed the implementation and ongoing costs associated with reform.

Ofgem has estimated combined implementation and ongoing costs for the reform of the GDN interruptions arrangements of between £40m and £53.6m. Approximately £6.9m of this can be attributed to implementation costs, with the remainder being the total for ongoing costs discounted over a 20 year period. Our analysis of the potential benefits of interruptions reform suggests that plausible assumptions about investment efficiency and lower costs of purchasing interruption can be expected to lead to the benefits of reform exceeding costs. For example, based on the GDNs capital expenditure forecasts submitted for the 2008-2013 price control review, an efficiency gain of between 2% and 2.6% on capital investment associated with LTS pipeline reinforcement, LTS storage and NTS offtake enhancement would lead to benefits exceeding costs.

Ofgem’s Final Impact Assessment on Modification Proposal 90[7] is being published at the same time as this decision letter. Following publication the Final IA will be available to view in full in the Gas Distribution Policy area of Ofgem’s work at Ofgem’s website www.ofgem.gov.uk.

The Authority’s decision

The Authority has considered the issues raised by the modification proposal and the Final Modification Report (FMR) dated 22 December 2006. 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]. The Authority has concluded that:

---

6 Reform of interruption arrangements on gas distribution networks – An update, Appendix 2 – Draft Impact Assessment, Ofgem, 31 October 2006

7 Reform of interruption arrangements on gas distribution networks – Final Impact Assessment, Ofgem, March 2007

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

1. implementation of the modification proposal will better facilitate the achievement of the relevant objectives of the UNC[9]; and
2. directing that the modification be made is consistent with the Authority's principal objective and statutory duties[10].

Reasons for the Authority's decision

In reaching this view the Authority considered whether or not the Proposal was likely to facilitate the achievement of the relevant objectives as set out in Standard Special Condition A11 (1) of the gas transporters licence.

1(a) the efficient and economic operation of the pipe-line system

The proposer was of the view that this objective would not be impacted by the Proposal

Ofgem's View

Ofgem's view is that the net effect of the proposal has the potential to facilitate the efficient and economic operation of the pipe-line system. In our Final IA we have identified costs associated with the implementation and ongoing operation of the proposal, but we anticipate that these costs will be outweighed by the collective benefits.

In moving from an administered system where the compensation customers can receive for being interruptible is limited to the flat use of system capacity discount, the reform proposal will allow customers the freedom to contract for interruption at the combination of price, volume and duration most economic to them. Allowing the GDNs to determine the volume of interruption they wish to purchase, has the potential to reduce the overall costs of purchasing interruption capacity.

In setting GDNs' price control incentives for purchasing interruption and NTS offtake capacity, Ofgem would seek to incentivise the GDNs to contract for interruption in a manner which was economically efficient. To the extent that it is efficient to minimise the cost of buying interruptible capacity, Ofgem would expect that the proposal would increase the efficient and economic operation of the pipe-line system. The amount the GDNs will pay for interruptible capacity will be recoverable through allowed revenue. This effectively means that through transportation charges all customers will pay for the amount the GDNs pay to interruptible customers for interruption. If the total amount paid is less than the total value of the current discount received by interruptible customers, this will amount to a reduction in the reallocation of revenue derived between firm and interruptible customers.

In addition, to the extent that interruptible customers perceive a different probability of being interrupted under a reformed regime, the reform proposal could increase the efficiency of the operation of the pipe-line system if it creates greater confidence in interruptible customers' preparedness to be interrupted. Ofgem notes that under the existing interruption arrangements very few customers have been interrupted in recent years, and that this may lead to some customers having very low expectation of being interrupted.

[9] As set out in Standard Special Condition A11(1) of the Gas Transporters Licence, see: http://62.173.69.60/document_fetch.php?documentid=6547
[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.

1(b) the co-ordinated, efficient and economical operation of (i) the combined pipe-line system, and/or (ii) the pipe-line system of one or more other relevant gas transporters

While the proposer was of the view that this objective would not be impacted by the Proposal they did point out that the development of the Proposal had involved all the GDNs and, that by implementing the Proposal through the UNC, similar arrangements would apply in each GDN, thereby avoiding inappropriate and unnecessary fragmentation. The proposer stated that the Proposal had been reviewed in the light of current NTS Capacity booking arrangements and also in the light of Modification Proposal 0116 “Reform of the NTS Offtake Arrangements”. One outcome of this review was a concern that simultaneous implementation of the NTS Exit regime and this Proposal might increase various risks for the industry as a whole.

One respondent, EDF, stated that if all NSLs were to go firm, this could have an impact on the system.

Ofgem’s View

Ofgem welcomes the joint effort that has been made by GDNs in bringing this Proposal forward and agrees that the UNC is the appropriate vehicle for introducing the new arrangements on a system wide basis.

Ofgem is of the view that the Proposal will permit GDNs to make better informed decisions regarding the various network management tools available, one of these being NTS offtake capacity. In addition the Proposal will enable GDNs to have greater certainty about the level of interruption available to them into the future.

Ofgem is of the view that any impact on the operation of the system from Network Sensitive Loads (NSLs) becoming firm will be mitigated by the period of three years between the first interruption application process and the commencement of the new arrangements. Ofgem does not agree that it will be in the economic interests of all customers currently deemed NSLs to elect to go firm following the implementation of interruption reform.

1(c) the efficient discharge of the licensee’s obligations under this licence

The proposer believes that the Proposal is consistent with the efficient discharge of the licensee’s obligations with respect to Standard Special Condition D8 Reform of Distribution Network Interruption Arrangements. It is also the proposer’s view that ‘implementation would enable GDNs to determine the quantity of Interruption purchased to meet their 1-in-20 licence obligation and customers to indicate their preferred terms of Interruption. This would allow the DNs to make informed decisions about investment in their networks’. In so doing the Proposer believes that implementation of the proposal would facilitate discharge of licence obligations with respect to the economic and efficient development of GDN systems.

Respondents recognised that implementation of the Proposal may allow the value of Interruption to be revealed, but some outlined concerns that if customers interest in bidding for interruptible services was less than anticipated the cost of buying interruptible capacity could be higher in a revised regime, and might in some instances trigger pipe-line investments which would not otherwise be necessary. Some respondents were also concerned that the potential costs of developing processes to value and offer interruption services to the GDNs may exceed the perceived benefits.

Ofgem's View

Ofgem's view is that implementation of the proposal has the potential to increase the effectiveness of interruptible capacity as a capacity management tool for the GDNs. The effectiveness of interruptible capacity to the GDNs is currently limited by the fact that they have limited control over the volume and location of such capacity on their networks. This means that, while interruptible capacity makes a significant contribution to the GDN's ability to manage its gas transportation obligations, the GDN cannot optimise the use of interruptible capacity to affect the efficiency of its investment decisions.

Implementation of the Proposal will permit the GDNs to control the volume and location of interruption that they contract for, while holding interruption application tenders three years in advance of the gas year to which the rights apply will provide GDNs with greater certainty over the future intentions of gas customers on their networks.

In an environment where a wide range of factors influence investment decisions, Ofgem is careful not to suggest that changing the interruption arrangements in this way will provide the GDNs with perfect economic trade-offs between purchasing interruptible capacity, investing in storage, reinforcing their pipe-line network and buying NTS offtake capacity, but we are of the view that the proposal will contribute positively to the economic efficiency of the decisions taken. This view is set out in detail in our Final Impact Assessment where we have indicated that relatively small capital investment savings would lead to the benefits of reform exceeding the costs. To the extent that investment efficiencies can be achieved we agree with the proposer's view that implementation would facilitate the GDNs licence obligations with respect to the economic and efficient development of their pipe-line systems.

1 (d) securing of effective competition between relevant shippers, relevant suppliers and gas transporters

While the proposer believed that competition between shippers would be increased by their tendering of interruption rights on behalf of customers, neither shippers nor customers took this view. Concerns were expressed with regard to the flow of relevant information regarding interruption when customers were switching between suppliers. It was also believed that increased costs and risks associated with the Proposal might deter some shippers / suppliers from competing in this segment of the market. Respondents also recognised that the Proposal was likely to lead to GDNs managing their need for interruption in different ways so facilitating comparative regulation.

Ofgems View

Ofgem is of the view that, as the detail of interruptible arrangements are held by customers they will form part of normal contractual negotiations between customers and suppliers and that therefore this aspect of the proposal should not impact upon competition. Ofgem has recognised in the IA that shipper costs will increase should the Proposal be implemented; while this may deter some from competing in this segment of the market, even if this were the case, there should remain a sufficient number of market participants to ensure effective competition. Ofgem is of the view that the new arrangements have the potential to greatly enhance the comparative regulation of GDNs as they will reveal detailed information not only in regard to purchasing interruption but also network management and capital expenditure. As shown by the IA this could prove a major source of benefit from the new arrangements.

1(e) 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

The proposer did not believe that the Proposal had any impact on this objective

Ofgem's View

Ofgem recognises that the Proposal will not impact on the incentives that exist for suppliers to ensure supply security for their domestic customers. However Ofgem is of the view that the Proposal will enhance security of supply more generally. For the first time GDNs will be required objectively to make decisions about the location and volume of interruption required for network security. These decisions will need to be based on objective criteria which can then be assessed as appropriate. In addition the potentially greater probability of being interrupted under the new regime will ensure that customers deemed to be interruptible are prepared for the consequences of their decisions and are therefore a more certain option for GDNs.

Conclusion

Ofgem is therefore of the view that the Proposal will facilitate many of the relevant objectives of Standard Special Condition A11(1), in particular by promoting the efficient development of distribution networks and promoting competition between GDNs through comparative regulation. Furthermore Ofgem is of the view that in doing so the Proposal will further the Authority's primary objective to protect the interests of consumers, present and future, where appropriate by promoting effective competition.

Next Steps

Since Modification Proposal 90 was raised in July 2006, it has been envisaged that implementation would be with effect from 2010/11. Under the reform proposals interruption contracts would be agreed with 3 year lead times, and so this implies holding a first interruptible capacity auction in June 2007.

Implementing interruption reform in 2010/11 would require Ofgem to set a one year interruption and NTS exit capacity incentive for the GDNs ahead of the first interruptible application process in June 2007. In Ofgem's view this implementation timescale is tight but achievable. However, given the importance of making the first interruptible application process a success and the complexity of setting incentives in this area, we have also considered the possibility that implementation of Mod 90 be delayed by one year to April 2008, so that the first application process would take place in June 2008.

Ofgem has identified a number of advantages of delaying implementation by one year

- The success of the reformed interruption arrangements will depend in large part on the willingness of customers to participate in the interruptible application process. In most cases they are currently a fairly passive recipient of a discount to their transportation charges. The role of GDNs in promoting the new process is integral to its success, and if the GDNs have longer to educate customers about the potential benefits available a positive response is more likely. Daily metered customers are being asked to participate in processes that are new and require more complex evaluations of the value of being interrupted, so more time to develop consumer understanding can help the success of reform.

- To implement interruption by 2010/11 a one year incentive would be required. Setting this in time for the June 2007 interruptible capacity auction is tight and leaves little time to decide how to deal with difficult policy questions that may arise. The incentive would need to be set before Ofgem had reached a view on the GDNs capex requirements. Ideally capex allowances and interruption incentives would be set at the same time and would be aligned with NTS exit capacity incentives. The fact that the outcome of UNC modification proposal 116 'NTS Offtake arrangements' will not be known until the end of March 2007 at the earliest adds additional complexity to this issue.
- The HSE recently indicated that they would not be in a position to approve the safety case implications of the Proposal in advance of Ofgem's decision on the Proposal. Following initial discussions with the GDNs the HSE have indicated that they would have concerns if the Mod 90 proposals resulted in the GDNs having access to a different volume of interruptible capacity than they do currently. The HSE consider that GDN interruptible capacity enhances security of supply in emergency gas supply circumstances. Delaying implementation would mean that there would be over a year for the HSE and GDNs to resolve this issue before the first application process takes place in June 2008 giving GDNs plenty of time to take any remedial actions, including further UNC Modification if necessary, to deal with any concerns raised by the HSE.
- One GDN has indicated that it would save some implementation costs from a one year delay because the increased lead time would remove the need for some short term IT changes for the June 2007 application process. The other GDNs might be in a similar position.

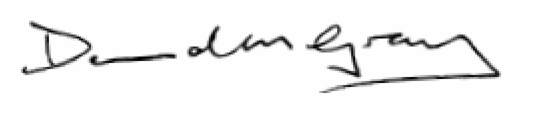
Ofgem has also identified disadvantages from delaying implementation by one year

- Setting a one year incentive for interruption purchases in 2010-11 would have revealed some information to inform the setting of incentives for the remainder of the next gas distribution price control review (the 18 months starting in October 2011) and the setting of Capex allowances. This information may have allowed the main GDPCR interruption incentives to be set more effectively, but it is unlikely that firm conclusions for future incentives could be drawn from one year's worth of information. We will need to consider as part of the price control review the most appropriate way of addressing any changes in Capex requirements that may arise from the first year of the new interruption arrangements.

After due consideration Ofgem considers that without a longer period of time between a decision to implement and implementation itself, there is a risk that customers and shippers will not be fully engaged in the process. Ofgem believes that a delay is essential for the Proposal's successful implementation and has therefore decided to direct implementation of the Proposal from April 2008.

Decision notice

In accordance with Standard Special Condition A11 of the Gas Transporters Licence the Authority hereby directs that modification proposal UNC 90: Revised DN Interruption Arrangements be made from 1 April 2008.



David Gray,
Managing Director, Networks

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