

Section 38A notice in respect of reasons for the decision to modify the licence of National Grid Gas plc

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Target Audience: National Grid Gas NTS, gas shippers, entry terminal operators and other interested parties

Overview:

This document sets out the reasons for the decision to modify the special conditions of National Grid Gas plc's gas transporters licence under section 38A of the Gas Act 1986 to incorporate in its licence the new entry capacity baselines produced by the transmission price control process.

In summary Ofgem has made this decision because:

- (i) it implements an aspect of the transmission price control process; and
- (ii) early introduction of this licence modification allows the Annual Monthly System Entry Capacity auctions to be held without waiting for implementation of the rest of the transmission price control proposed licence modifications.

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Context

Ofgem's Transmission Price Control Review (TPCR) Final Proposals (TPCR Final Proposals) were issued in December 2006. Ofgem subsequently decided that it would be desirable to implement these proposals in two stages, the first stage to bring forward the proposed licence modifications deemed necessary to ensure that the commercial framework from 1 April 2007 is aligned with the new proposals and the second stage to introduce the rest of the proposed licence modifications to the TPCR Final Proposals.

This document sets out Ofgem's decision to modify National Grid Gas Plc (NGG) licence to implement the first stage of the TPCR Final Proposals.

Associated Documents

- "Transmission Price Control Review - Initial Consultation", Ofgem, July 2005
- "Transmission Price Control Review - Second Consultation", Ofgem, December 2005
- "Transmission Price Control Review 2007-2012: Third Consultation", Ofgem, March 2006
- "Transmission Price Control Review - Initial Proposals", Ofgem, June 2006
- "Transmission Price Control Review - Updated Proposals", Ofgem, September 2006
- "Transmission Price Control Review - Draft licence modifications", Ofgem, November 2006
- "Transmission Price Control Review - Final Proposals", Ofgem, December 2006
- "Transmission Price Control Review: Draft licence conditions (gas) 2nd informal consultation", Ofgem, January 2007
- "Notice under section 23 (3) of the Gas Act 1986", Ofgem, February 2007

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Summary

Transmission Price Control Review Process

Over the past two years Ofgem has been in the process of reviewing the price control of National Grid Gas NTS (NGG NTS). The price control determines how much revenue NGG NTS is permitted to recover and sets out what NGG NTS is expected to deliver in exchange for this revenue allowance. This is an important process to ensure continuing effective regulation of network monopolies by implementing provisions so that the companies can finance their activities and by providing the companies with the right set of financial incentives to act in the interests of consumers.

This consultative process concluded with the publication of final proposals in December 2006. In order to give effect to the proposals, however, Ofgem must modify the gas transporters licence held by NGG NTS. It is important that the licences reflect the policy as set out in the final proposals document in an accurate and unambiguous manner.

Ofgem is continuing to work on the formal licence modifications to implement the full package of the gas transmission price control review (TPCR) measures. As an interim measure Ofgem has sought to implement the first stage of the price control package (ie that desirable for the continued operation of the regulatory and commercial regime) in advance of implementing the rest of the proposed licence changes. In February 2007 Ofgem issued a statutory consultation under section 23(3) of the Gas Act 1986 (Gas Act) on this first stage of the proposed licence modifications.

Representations made

Responses to the section 23 consultation indicated concerns from a variety of parties about the package of proposals for gas entry capacity baselines contained in Ofgem's TPCR Final Proposals document. Ofgem has considered these representations and, does not agree with the views that the methodology used to determine these baselines capacities was inappropriate in the various ways suggested by the respondents or that Ofgem's TPCR consultation process was inadequate.

Ofgem's decision

Ofgem has therefore decided to implement the proposed licence modifications in full. This document sets out the reasons for that decision.

1. Background

Transmission Price Control Review Process and outputs

1.1. In December 2006 Ofgem published TPCR Final Proposals for the transmission price control review ("The Final Proposals Document")¹ setting out Ofgem's proposed changes to the licence obligations and remuneration of NGG NTS (i.e. National Grid Gas acting as operator of the National Transmission System) for the period from 1st April 2007. Amongst other matters the TPCR Final Proposals Document set out changes to the baseline levels of obligated entry capacity release (baselines) at the various entry points on the National Transmission System (NTS).

1.2. The Final Proposals Document was the culmination of a lengthy consultation exercise which started in July 2005² which comprised several consultation documents, bilateral meetings, multilateral meetings and workshops. These proposals were accepted in principle by NGG NTS on 15 December 2006. The final stage of the TPCR process is to modify the licence of NGG NTS to implement the TPCR policies in full.

1.3. Ofgem is continuing to develop the legal text necessary to implement the full package of proposed measures, with the current intention of issuing the proposed licence changes for consultation towards the end of April 2007. However, Ofgem has identified aspects of the final proposals that require implementation by 1 April 2007 in order for the commercial regime to operate in a manner consistent with the revised regulatory regime. In the light of this, Ofgem consulted upon proposed licence modifications pursuant to section 23 of the Gas Act to implement these features of the regime.

The Annual Monthly System Entry Capacity auctions

1.4. Under normal circumstances the Annual Monthly System Entry Capacity (AMSEC) auctions in respect of entry capacity for the period of two years starting on 1 April 2007 would have been held in February 2007. Under the provisions of the uniform network code (UNC) in these auctions NGG NTS offers for sale unsold entry capacity according to the obligations (including the baselines) specified in NGG NTS's licence in force at that time. Since the AMSEC auctions were due to take place in February, they would have taken place in a manner that reflected the baseline entry capacity values set under the regime in place until 31 March 2007, rather than the proposed regime that will operate from 1 April 2007.

¹ "Transmission Price Control Review - Final Proposals", Ofgem, December 2006

² "Transmission Price Control Review - Initial Consultation", Ofgem, July 2005

Network Code Modifications

1.5. NGG NTS was concerned about this misalignment of obligations relating to entry capacity between the AMSEC auctions and its licence obligations which would take effect from 1 April 2007. Consequently NGG NTS brought forward two urgent code modifications (UNC128 and UNC129³) to attempt to remedy this problem.

1.6. Ofgem directed that UNC129 be made which had the effect of delaying the announcement of the AMSEC auctions until after Ofgem had modified the baselines in NGG NTS's licence pursuant to the Gas Act.

Ofgem's interim s23 notice

1.7. In order to avoid delaying the AMSEC auctions more than necessary Ofgem decided that it should seek to modify the baselines in advance of the introduction of the rest of the TPCR Final Proposals, which was likely to be implemented at a later date with retrospective effect from 1st April 2007. Ofgem, therefore, to implement the first stage of TPCR final proposals, issued on 16th February 2007 a notice pursuant to section 23 (3) of the Gas Act proposing to modify the conditions of NGG NTS's licence by removing Table A2: Initial NTS SO baselines entry capacity (GWh/day) from Schedule A: NTS output measures for the price control and replacing them with the table set out in the Appendix to that notice (Interim Section 23).

1.8. Subsequent chapters of this document discuss the responses received to the licence modification proposals set out in the Interim Section 23 and sets out Ofgem's reasons for its decision to modify NGG NTS's licence.

³ Details of these modifications can be found on the website of the Joint Office of Gas Transporters at <http://www.gasgovernance.com/Code/Modifications/ClosedMods/CM121-130/>

2. Responses to Ofgem's Interim s23 notice - and Ofgem's comments thereon.

Responses received

2.1. Ofgem received 10 responses to the licence modification proposals set out in the Interim Section 23 of which 2 were marked as confidential and Ofgem also received NGG's consent to the proposed modification to its licence. The non-confidential respondents were:

- BP
- British Gas Trading
- Centrica Storage Limited
- Excelerate Energy
- E.ON UK
- PX(TGPP) Limited
- RWE npower
- Scottish & Southern Energy

2.2. One other gas shipper not mentioned here has also made informal representations to Ofgem on matters relating to this licence modification.

Views on the TPCR proposals

2.3. Many of the respondents used this statutory consultation as an opportunity to express their opinions on TPCR Final Proposals. Some respondents expressed the view that it was inappropriate or undesirable for baselines to change significantly or that it was inappropriate for baselines to change in a downwards direction.

2.4. An important concern expressed about the changing baselines from respondents is that by changing the baselines Ofgem has introduced a degree of regulatory uncertainty into the gas entry regime.

2.5. Some respondents expressed the view that in developing its final proposals for the TPCR Ofgem should have had regard to actual level of flows at entry points on the network which have occurred in the past, the implication being that baselines should be no lower than the highest level of flow seen. In support of this some respondents indicated that the presence of zero reserve prices for daily capacity should be taken account of when setting price controls.

2.6. Certain respondents expressed concern that Ofgem had, in setting the baseline, ensured that no baseline was below the level of capacity already sold to shippers at that entry point. Concern was expressed that setting baselines at the level of sold capacity changed the meaning of baselines from a measure of network capability to one of a reflection of previous commercial decisions by shippers.

Ofgem's response

2.7. Ofgem notes the view of shippers that regulatory imposed changes in baseline entry capacity are inefficient and cause uncertainty to shippers. Eliminating this feature of the system for future price control reviews was an important part of the reason Ofgem proposed in the March document⁴ for removing the baseline obligations and instead having NGG NTS have a capacity release methodology backed up by a fully populated network model. However at this price control review Ofgem accepted the views of respondents (particularly gas shippers) that, at that time, moving to such a model at this time would not be desirable and so Ofgem reverted to a system of regulatory imposed baselines.

2.8. It is unlikely that the network conditions in operation prior to the previous price control (i.e. before 1 April 2002) when the network modelling to generate the current baselines was carried out will be unchanged five years later (and even less likely that they will stay unchanged for the following five years). Necessarily therefore in the price control system the baselines set will change at price control reviews. Such uncertainty is a feature of this regime and is not something specific that Ofgem has introduced by its approach to the TPCR.

2.9. In paragraph 10.4 of its Final Proposals Document Ofgem set out the position on the baseline proposals:

"We have sought to set baselines that reflect the physical capability of the network. We have used network modelling to estimate these capabilities. We have sought to characterise the maximum capacity that can be released at each entry point at system peak given the current intact network and assuming flows at nearby entry points are also relatively high. This, in our view, gives a conservative but realistic view of the physical capability of the network. It also gives baselines which are, in our view, consistent with the allowances we have made for NGG NTS in respect of the costs of buying back capacity."

2.10. Further detail on Ofgem's approach was provided in Appendix 8 of the TPCR Final Proposals and in response to questions from the gas transmission workstream on 1st March 2007⁵.

2.11. In addition Ofgem's TPCR proposals contain other elements that have an effect on the availability of capacity to shippers who wish to make use of it. In particular Ofgem has proposed introducing licence obligations on NGG NTS to allow for the transfer and trade of entry capacity between different entry points.

2.12. Ofgem rejects the view that it should have ensured that baselines are no lower than the level of outturn flows at given entry points. Depending on flows elsewhere on the network the level of flows that can be accommodated at a given entry point

⁴ "Transmission Price Control Review 2007-2012: Third Consultation", Ofgem, March 2006

⁵ Copies of the questions and Ofgem's response can be found on the website of the Joint Office of Gas Transporters at <http://www.gasgovernance.com/Code/Workstreams/TransmissionWorkstream/2007Meetings/>

can vary significantly. It was for this reason that the gas entry system was designed to allow NGG to not deliver capacity (i.e. buy it back) or to deliver capacity beyond its obligations (i.e. to release non-obligated and interruptible capacity). Ofgem did not therefore consider it appropriate to have regard to actual historic flows when calculating the baselines or to ensure the baselines were above such levels. However flow *forecast* assumptions (from NGG NTS's Transporting Britain's Energy process) were used as an input into the model that developed the baseline proposals.

2.13. In considering this it is important to note that the baselines are an obligation on NGG NTS to provide capacity and not a right possessed by shippers. The fact that a given shipper may have been intending to purchase (at zero price) capacity does not mean that it has a right to that capacity.

2.14. In setting the baselines Ofgem was concerned to ensure that the regulatory obligations on NGG NTS to release capacity (through the price control) were not inconsistent with its future commercial obligations to release capacity (through contracts with shippers). Ofgem therefore determined that, of the various patterns of baselines which could have been imposed, it would confine itself to considering ones that set the baseline levels at or above the future obligated capacity already sold at each entry point. In imposing this constraint Ofgem has not therefore stopped baselines representing physical capability of the network. Ofgem set out its intention to impose this restriction in the Updated Proposals Document in September and stated there that:

"We would intend that the initial baselines be chosen from that sub-set of possible baselines wherein no baseline is less than the amount of obligated capacity NGG NTS has already sold in respect of that entry point."

and that

" In order to implement this change, we plan to increase baselines at some entry points to reflect past sales of obligated capacity, and to turn down baselines at other entry points within the same "zone" (as defined in a recent paper by NGG NTS on the release of entry capacity in the constrained period) on a pro rata basis, in order to keep the total system capability implied by the baselines constant relative to the June initial proposals. This means we plan to turn down baselines at other entry points within the same zone relative to the baselines figures for these other entry points in our June initial proposals."

Views on TPCR process

2.15. Several respondents also took the opportunity to comment on the TPCR process and, in particular, their opinion that they had not been provided with sufficient opportunity to comment on the methodology used by Ofgem to determine the baseline levels of entry capacity.

Ofgem's response

2.16. The TPCR process took place over two years and throughout this time Ofgem sought comment from respondents on its modelling approach to the gas entry regime.

2.17. Respondents to the TPCR documents⁶ were generally supportive of Ofgem's change to a methodology based on practical maximum physical capacity rather than theoretical maximum physical capacity, a change which would necessarily lead to differences in baseline numbers.

2.18. However respondents did not typically (with the exception of NGG NTS) provide detailed suggestions or comments on the appropriate methodology to be used for network capability assessment. Ofgem considered the representations made and used the views expressed to develop its TPCR Final Proposals.

2.19. In response to the view of some respondents that they did not have sufficient notice that there was scope for the baselines to change between Updated Proposals (September 2006) and Final Proposals (December 2006) Ofgem notes that Appendix 9 of the Updated Proposals Document set out numerically the level of difference between Ofgem's position then and that of NGG NTS and commented that

"We intend to set baselines at levels consistent with the simultaneous physical accommodation of possible flows under a wide range (although not all possible) scenarios across entry points. This means that we intend to set baselines such that exposure to (operational) buy back risk will be residual, and relatively low. For the avoidance of doubt this does not mean that the network needs to be designed to accommodate simultaneous flows at each entry point at the level of the baselines. Further analysis is required to assess the operational buy-back risks associated with different baseline proposals, in particular NGG NTS's views on the risks of Ofgem's proposals. We will continue working with NGG NTS to assess such risks and try and quantify them"

and further stated that " If the buy-back risks associated with our revised baseline proposals are relatively high, we are likely to adjust them downwards" which clearly indicated that there was still significant disagreement with NGG NTS on the baseline levels and ongoing work which could result in changes.

2.20. Ofgem therefore considers that its consultation process was both lengthy and transparent and that respondents had sufficient opportunity to involve themselves in the development of the methodology used for determining baselines. On this basis Ofgem did not consider that it was appropriate to delay finalising its TPCR Final Proposals beyond the deadline established early in the consultation process (i.e. Final Proposals in December 2006).

⁶ The non-confidential responses to the TPCR documents can be found on Ofgem's website www.ofgem.gov.uk or can be obtained from Ofgem's library (library@ofgem.gov.uk).

Views of the timing of the implementation of TPCR

2.21. A view was expressed that Ofgem should implement all the aspects of the TPCR Final Proposals together and asked that Ofgem not make a decision on the licence modification proposals set out in the Interim Section 23 until it was ready to make a decision on the TPCR as a whole. This respondent commented that this would mean holding an AMSEC auction using the current baselines and that this would provide appropriate incentives to NGG NTS.

2.22. Several other respondents expressed the view that if this change needs to be implemented then it needs to be implemented in a timely fashion.

Ofgem's response

2.23. Ofgem notes that only a minority of shippers expressed a view that the AMSEC auction should be further delayed by delaying the implementation of the modifications to NGG NTS's licence proposed by the Interim Section 23. Ofgem therefore continues to consider that it is desirable to allow the AMSEC auction to happen in the most timely fashion possible

Views of the licensee (NGG NTS)

2.24. NGG NTS has indicated its consent to the proposed licence modifications.

3. Ofgem's decision

3.1. Following consideration of the representations made and on the basis of the reasoning set out in chapter 2 of this document Ofgem is of the opinion that the proposals contained in its TPCR Final Proposals were appropriate. Ofgem has therefore considered that, despite the views expressed in these responses, it is appropriate to modify NGG NTS's licence as proposed in the Interim Section 23 and such a decision to modify NGG NTS's licence was issued on 30th March 2007 by the Authority pursuant to the powers contained in section 23(1) A of the Gas Act and with effect on and from 06:00 on 1st April 2007.

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Appendix 1 – The Authority's Powers and Duties

1.1. Ofgem is the Office of Gas and Electricity Markets which supports the Gas and Electricity Markets Authority ("the Authority"), the regulator of the gas and electricity industries in Great Britain. This Appendix summarises the primary powers and duties of the Authority. It is not comprehensive and is not a substitute to reference to the relevant legal instruments (including, but not limited to, those referred to below).

1.2. The Authority's powers and duties are largely provided for in statute, principally the Gas Act 1986, the Electricity Act 1989, the Utilities Act 2000, the Competition Act 1998, the Enterprise Act 2002 and the Energy Act 2004, as well as arising from directly effective European Community legislation. References to the Gas Act and the Electricity Act in this Appendix are to Part 1 of each of those Acts.⁷

1.3. Duties and functions relating to gas are set out in the Gas Act and those relating to electricity are set out in the Electricity Act. This Appendix must be read accordingly⁸.

1.4. The Authority's principal objective when carrying out certain of its functions under each of the Gas Act and the Electricity Act is to protect the interests of consumers, present and future, wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities connected with, the shipping, transportation or supply of gas conveyed through pipes, and the generation, transmission, distribution or supply of electricity or the provision or use of electricity interconnectors.

1.5. The Authority must when carrying out those functions have regard to:

- The need to secure that, so far as it is economical to meet them, all reasonable demands in Great Britain for gas conveyed through pipes are met;
- The need to secure that all reasonable demands for electricity are met;
- The need to secure that licence holders are able to finance the activities which are the subject of obligations on them⁹; and
- The interests of individuals who are disabled or chronically sick, of pensionable age, with low incomes, or residing in rural areas.¹⁰

1.6. Subject to the above, the Authority is required to carry out the functions referred to in the manner which it considers is best calculated to:

⁷ entitled "Gas Supply" and "Electricity Supply" respectively.

⁸ However, in exercising a function under the Electricity Act the Authority may have regard to the interests of consumers in relation to gas conveyed through pipes and vice versa in the case of it exercising a function under the Gas Act.

⁹ under the Gas Act and the Utilities Act, in the case of Gas Act functions, or the Electricity Act, the Utilities Act and certain parts of the Energy Act in the case of Electricity Act functions.

¹⁰ The Authority may have regard to other descriptions of consumers.

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- Promote efficiency and economy on the part of those licensed¹¹ under the relevant Act and the efficient use of gas conveyed through pipes and electricity conveyed by distribution systems or transmission systems;
 - Protect the public from dangers arising from the conveyance of gas through pipes or the use of gas conveyed through pipes and from the generation, transmission, distribution or supply of electricity;
 - Contribute to the achievement of sustainable development; and
 - Secure a diverse and viable long-term energy supply.

1.7. In carrying out the functions referred to, the Authority must also have regard, to:

- The effect on the environment of activities connected with the conveyance of gas through pipes or with the generation, transmission, distribution or supply of electricity;
- The principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed and any other principles that appear to it to represent the best regulatory practice; and
- Certain statutory guidance on social and environmental matters issued by the Secretary of State.

1.8. The Authority has powers under the Competition Act to investigate suspected anti-competitive activity and take action for breaches of the prohibitions in the legislation in respect of the gas and electricity sectors in Great Britain and is a designated National Competition Authority under the EC Modernisation Regulation¹² and therefore part of the European Competition Network. The Authority also has concurrent powers with the Office of Fair Trading in respect of market investigation references to the Competition Commission.

¹¹ or persons authorised by exemptions to carry on any activity.

¹² Council Regulation (EC) 1/2003

Appendix 2 - Glossary

A

AMSEC

Annual Monthly System Entry Capacity

N

NGG NTS

National Grid Gas NTS

NTS

National Transmission System

T

TPCR

Transmission Price Control Review

U

UNC

Uniform Network Code

Appendix 3 - Feedback Questionnaire

1.1. Ofgem considers that consultation is at the heart of good policy development. We are keen to consider any comments or complaints about the manner in which this consultation has been conducted. In any case we would be keen to get your answers to the following questions:

- Does the report adequately reflect your views? If not, why not?
- Does the report offer a clear explanation as to why not all the views offered had been taken forward?
- Did the report offer a clear explanation and justification for the decision? If not, how could this information have been better presented?
- Do you have any comments about the overall tone and content of the report?
- Was the report easy to read and understand, could it have been better written?
- Please add any further comments?

1.2. Please send your comments to:

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