

Modification proposals:	<b>Uniform Network Code (UNC) 0501V: Treatment of Existing Entry Capacity Rights at the Bacton ASEP to comply with EU Capacity Regulations (UNC501V); UNC 0501AV: Treatment of Existing Entry Capacity Rights at the Bacton ASEP to comply with EU Capacity Regulations including capacity return option (UNC501AV); UNC 0501BV: Treatment of Existing Entry Capacity Rights at the Bacton ASEP to comply with EU Capacity Regulations including a restricted capacity return option (UNC0501BV); UNC 0501CV: Treatment of Existing Entry Capacity Rights at the Bacton ASEP to comply with EU Capacity Regulations including a capped capacity return option and an aggregate overrun regime (UNC501CV)</b>		
Decision:	The Authority <sup>1</sup> directs that modification UNC501V be made. <sup>2</sup>		
Target audience:	UNC Panel, Parties to the UNC and other interested parties		
Date of publication:	20 July 2015	Implementation date:	As soon as practicable

## Background

The Network Code on Capacity Allocation Mechanisms in Gas Transmission Systems (CAM) was published in the Official Journal of the European Union (OJEU) on 15 October 2013 and applies from 1 November 2015.<sup>3</sup> We describe the background and aims of CAM in more detail in Annex I to this letter.

On 10 February 2015 we published our decision setting out how we would facilitate the implementation of CAM in Great Britain (GB).<sup>4</sup> We said that CAM would be implemented at Interconnection Points (IPs) only – within GB this is Bacton and Moffat. We also noted that the current Bacton entry point is unique in that gas enters GB at that point from both domestic sources and via interconnectors with Belgium (Interconnector UK (IUK)) and the Netherlands (the Balgzand Bacton Leiding pipeline (BBL)), and furthermore, that CAM does not apply to domestic production. We decided therefore that it was necessary to make changes to National Grid Gas plc’s (NGG’s) National Transmission System (NTS) gas transporter licence in order to facilitate implementation of CAM. This change splits the current Bacton entry point commercially into two new entry points to NGG’s system.<sup>5</sup> These two new entry points will be called Bacton UKCS and Bacton IP, effective from 1 November 2015 (or such other date as the Authority may direct in writing). The baseline capacity made available at the Bacton IP entry point will be the sum of the technical capacities of the two interconnectors, with the Bacton UKCS baseline set at the current

<sup>1</sup> References to the “Authority”, “Ofgem”, “we” and “our” are used interchangeably in this document. The Authority refers to GEMA, the Gas and Electricity Markets Authority. The Office of Gas and Electricity Markets (Ofgem) supports GEMA in its day to day work. This decision is made by or on behalf of GEMA.

<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> Commission Regulation establishing a Network Code on Capacity Allocation Mechanisms in Gas Transmission Systems (984/2013/EU): <http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:32013R0984>.

<sup>4</sup> Modification of Special Conditions 1A and 5F of National Grid Gas plc’s Gas Transporter Licence to facilitate implementation of the Capacity Allocation Mechanisms Network Code : <https://www.ofgem.gov.uk/publications-and-updates/modification-special-conditions-1a-and-5f-national-grid-gas-plc%E2%80%99s-gas-transporter-licence-facilitate-implementation-capacity-allocation-mechanisms-network-code>.

<sup>5</sup> Note that the split of Bacton is a notional split for operational purposes and there is no physical change to the Bacton infrastructure as a result of Ofgem’s decision.

Bacton baseline capacity less that of Bacton IP.<sup>6</sup> This is to ensure that CAM procedures are only applicable to capacity at the Bacton IP entry point.

Long-term bookings have already been allocated for entry capacity at the Bacton entry point for the period after the implementation of CAM (ie, post-split from 1 November 2015). This raises the question of what happens to capacity that shippers had bought for use at Bacton after the split (NTS entry capacity can be bought up to 15 years in advance).

### **The modification proposals**

Four UNC modifications were raised proposing different treatment of existing capacity bookings at Bacton after the split. These are described below.

#### *UNC501V Treatment of Existing Entry Capacity Rights at the Bacton ASEP<sup>7</sup> to comply with EU Capacity Regulations*

UNC501V was raised by NGG on 1 May 2014. This modification introduces a one-off process that invites capacity holders to indicate whether they wish their entry capacity rights at the existing Bacton entry point to be reallocated to the Bacton UKCS, or at the Bacton IP, entry point following implementation of CAM.

Where the aggregate level of capacity holders' requests for capacity to be reallocated to an entry point is less than or equal to the baseline capacity at that entry point, their entry capacity reallocations will be granted in full. If this is not the case, a further invitation and reallocation process will be undertaken.

If, after two such processes have been followed, the aggregate level of bookings to be reallocated is still in excess of the baseline capacity at one entry point, NGG will reallocate the requests on a pro rata basis (such that the baseline capacity is not exceeded by the aggregate level of capacity holdings). Any remaining capacity will be reallocated to the other entry point.

NGG considers that UNC501V facilitates UNC relevant objective (g).<sup>8</sup>

#### *UNC501AV Treatment of Existing Entry Capacity Rights at the Bacton ASEP to comply with EU Capacity Regulations, including capacity return option*

UNC501AV was raised by Centrica Energy on 23 July 2014. This modification is the same as UNC501V except it also provides a one-off opportunity for shippers to return all of their existing entry capacity bookings to NGG prior to the reallocation process described by UNC501V.

Furthermore, if shippers wish to reallocate holdings such that the baseline capacity at one of the entry points is exceeded by the requests to reallocate capacity there, and NGG are required to adjust shippers' desired reallocations in the way described above, the capacity holder will have a final opportunity to return capacity to NGG. In this instance

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<sup>6</sup> Baseline capacity is the amount of firm entry capacity NGG are obligated to make available as defined by NGG's gas transporter licence.

<sup>7</sup> ASEP refers to an Aggregate System Entry Point.

<sup>8</sup> UNC relevant objective (g) 'Compliance with the Regulation and any relevant legally binding decisions of the European Commission and/or the Agency for the Co-operation of Energy Regulators'.

they can return capacity up to the volume that has been reallocated against their original wishes.

Centrica Energy considers that UNC501AV facilitates UNC relevant objectives (b), (c) and (g).<sup>9</sup>

*UNC501BV Treatment of Existing Entry Capacity Rights at the Bacton ASEP to comply with EU Capacity Regulations, including a restricted capacity return option*

UNC501BV was raised by Centrica Storage Limited (CSL) on 10 October 2014. This modification follows the reallocation process described by UNC501AV except that there is no initial option to hand back all capacity.

CSL considers that UNC501BV facilitates UNC relevant objectives (b), (c) and (g).<sup>10</sup>

*UNC501CV Treatment of Existing Entry Capacity Rights at the Bacton ASEP to comply with EU Capacity Regulations, including a capped capacity return option and an aggregate overrun regime*

UNC501CV was raised by ENI UK on 7 November 2014. This modification is similar to the return and reallocation of capacity described by UNC501AV although the maximum that can be returned to NGG is capped at 72.77%.<sup>11</sup>

Furthermore, UNC501CV proposes that capacity that is reallocated to either of the entry points (defined in the modification as "Residual Capacity") can be used flexibly in an aggregate overrun plus rebate mechanism.

Currently shippers must hold entry capacity to flow onto the NTS at a single entry point. If they flow more than their capacity entitlement, they are liable for overrun charges. Under UNC501CV, a shipper holding Residual Capacity at Bacton UKCS (or Bacton IP) can use it to flow via Bacton IP, assuming they also hold interconnector capacity, (or Bacton UKCS) without facing an overrun charge even if they do not hold entry capacity there.

A rebate is also proposed where an existing capacity holder buys bundled Bacton IP capacity<sup>12</sup> after 1 November 2015 and the amount of this bundled Bacton IP capacity exceeds the sum of its unused Residual Capacity (where this has not been used to flow at the entry point directly or to avoid overrun charges at the other entry point).

ENI UK considers that UNC501CV facilitates UNC relevant objectives (b), (c), (d) and (g).<sup>13</sup>

## **UNC Panel<sup>14</sup> recommendation**

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<sup>9</sup> UNC relevant objective (b) 'Coordinated, efficient and economic operation of (i) the combined pipe-line system, and/or (ii) the pipe-line system of one or more other relevant gas transporters'. UNC relevant objective (c) 'Efficient discharge of the licensee's obligations'. See footnote 8 for UNC relevant objective (g).

<sup>10</sup> See footnote 9.

<sup>11</sup> This value was chosen as the Bacton IP entry point baseline capacity represents 72.77% of the Bacton entry baseline capacity.

<sup>12</sup> Currently to transport gas across an interconnection point between TSOs requires shippers to buy exit capacity from one TSO and entry capacity to the next TSO. Bundled capacity products means that shippers will buy the various capacity products to transport across an interconnection point in a single transaction. Bundled IP capacity means that it is a bundle of NGG entry capacity with either BBL exit capacity or IUK exit capacity.

<sup>13</sup> See footnote 9 plus UNC relevant objective (d) 'Securing of effective competition: (i) between relevant shippers; (ii) between relevant suppliers; and/or (iii) between DN operators (who have entered into transportation arrangements with other relevant gas transporters) and relevant shippers'.

At the UNC Panel meeting on 19 February 2015, a majority of the UNC Panel considered that UNC501V, UNC501AV, UNC501BV and UNC501CV would better facilitate the UNC objectives and therefore recommended implementation of all four modifications.<sup>15</sup>

The majority of UNC Panel members were unclear whether any of the four modifications furthered relevant objective (b). Panel members were split on whether the four modifications furthered relevant objective (d). Panel members agreed that implementation of any one of the four modifications would better facilitate compliance of relevant objective (g). Full details of the UNC Panel's discussions are available in the Final Modification Report (FMR).<sup>16</sup>

We published a notice that we intended to carry out an impact assessment (IA) on the four modifications on 1 April 2015 (this is described further below). As a consequence, we asked the UNC Panel to consider if further work was necessary to ensure the proposed legal text for each of the modifications in the FMR was resilient to our anticipated timing for the decision on the modifications. The four proposers subsequently submitted a variation request for each modification. These variation requests concerned timings only. The UNC Panel did not consider the variations to be material and the FMR was resubmitted to us on 1 May 2015.

### **Impact assessment**

On 20 May 2015, we published an IA on the four proposed modifications.<sup>17</sup> This is because we considered that the decision on the four proposed modifications was sufficiently important to warrant us carrying out an IA under the Utilities Act 2000.<sup>18</sup> We invited stakeholder views on the IA, and in particular, if there was any further quantitative and/or qualitative evidence of the potential impacts of the proposed changes not covered by our analysis.

Based upon the factors we examined in our IA, our initial conclusions can be summarised as follows:

- UNC501AV, UNC501BV and UNC501CV would all result in increased TO entry commodity charges for all GB shippers through the re-distributional effects of returning capacity to NGG. UNC501V would have no such effect.
- Separately, the implementation of either UNC501V, UNC501AV or UNC501BV would, when combined with our prior decision to implement CAM by splitting

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<sup>14</sup> The UNC Panel is established and constituted from time to time pursuant to and in accordance with the UNC Modification Rules.

<sup>15</sup> The eleven UNC Panel members assessed each modification individually and voted on whether to recommend implementation. Six UNC Panel members voted in favour of implementing UNC501V, nine voted in favour of implementing UNC501AV, eight in favour of implementing UNC501BV and six in favour of implementing UNC501CV. Therefore all were recommended for implementation by a majority of the UNC Panel. The Panel also expressed the view that no clear majority existed on the preference of whether Modification 0501V, 0501AV, 0501BV or 0501CV better facilitated the Relevant Objectives than the others.

<sup>16</sup> The final modification report can be found here: <http://www.gasgovernance.co.uk/0501>.

<sup>17</sup> Impact assessment of UNC modifications 0501V, 0501AV, 0501BV and 0501CV 'Treatment of Existing Entry Capacity Rights at the Bacton ASEP to comply with EU Capacity Regulations': <https://www.ofgem.gov.uk/publications-and-updates/impact-assessment-unc-modifications-0501v-0501av-0501bv-and-0501cv-treatment-existing-entry-capacity-rights-bacton-asep-comply-eu-capacity-regulations>.

<sup>18</sup> Section 5A of the Utilities Act 2000 places a duty on the Authority to carry out an IA where: the Authority is proposing to do anything for the purposes of, or in connection with, the carrying out of any function exercisable by it under or by virtue of Part 1 of the Gas Act 1986 or Part 1 of the Electricity Act 1989; and it appears to the Authority that the proposal is "important" within the meaning of section 5A.

Bacton, lead to a reduction in flexibility at Bacton; further, this reduction in flexibility would be concentrated on shippers continuing to hold capacity at Bacton after 1 November 2015 under any of these modifications. While UNC501CV seeks to mitigate this reduction in flexibility via the aggregate overrun plus rebate mechanism, we considered that this goal can also be achieved through other market mechanisms that allow shippers to acquire capacity at either of the Bacton entry points at no additional cost.<sup>19</sup> On balance, we considered the positive elements of UNC501CV with respect to flexibility were outweighed by the negative implications of capacity handback.

The rebate mechanism may also have some unintended consequences for one of the principles underpinning the capacity regime, namely that shippers are responsible for buying the capacity they need ('ticket to ride'). It is up to the shipper to manage the risk of buying more or less capacity than they need.

We considered that there will be minimal impacts on consumers' bills directly from any of the four proposed modifications, as NGG's allowed revenue will remain unchanged. However, any impact on competition or costs (including redistribution of costs between market participants) associated with implementing the modifications may indirectly affect consumers' bills.

We quantified the impact of each proposal where we could in the IA. In doing so we looked at the impact of different levels of capacity return including the maximum that could be returned under the four proposals. We did not consider that further, more granular, quantitative analysis would have added significantly more value. Where we were unable to quantify the impacts of the modification proposals we instead set out our understanding of the qualitative arguments.

The responses to the IA have been beneficial in furthering our thinking of the relative weight to be attached to the qualitative arguments.

## **Our decision**

We have considered the issues raised by the modifications and the FMR dated 1 May 2015. We have considered and taken into account the responses to the industry consultations on the modification proposals which are attached to the FMR<sup>20</sup>, as well as responses to the IA carried out by Ofgem.<sup>21</sup> We have concluded that:

- implementation of modification UNC501V will better facilitate the achievement of the relevant objectives of the UNC;<sup>22</sup> and
- directing that modification UNC501V be made is consistent with our principal objective and statutory duties.<sup>23</sup>

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<sup>19</sup> These other market mechanisms include the ability to buy capacity at zero reserve price auctions in the short-term timeframe, trade capacity on the secondary market or surrender capacity to NGG.

<sup>20</sup> UNC modification proposals, modification reports and representations can be viewed on the Joint Office of Gas Transporters website at [www.gasgovernance.co.uk](http://www.gasgovernance.co.uk).

<sup>21</sup> See footnote 17.

<sup>22</sup> As set out in Standard Special Condition A11(1) of the Gas Transporters Licence, available at: <https://epr.ofgem.gov.uk/Content/Documents/Standard%20Special%20Condition%20-%20PART%20A%20Consolidated%20-%20Current%20Version.pdf>.

<sup>23</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 as amended.

## Summary of the reasons for our decision

Overall, we consider that UNC501V better facilitates the achievement of the UNC relevant objectives than the other three modification proposals.

We consider that all four modifications improve the efficient and economic operation of the NTS against the counterfactual of doing nothing. This is because they allow existing Bacton entry capacity holders to use their existing capacity at whichever of the entry points they choose to reallocate it to. However, we consider that there are negative consequences of capacity hand-back, associated with UNC501AV, UNC501BV and UNC501CV on economic and efficient use of the NTS.

Regarding UNC501AV and UNC501BV:

- The negative effects of hand-back from UNC501AV and UNC501BV means that we consider that UNC501V furthers the relevant objectives more than these two modifications when these are weighed up in aggregate.
- There would also be negative impacts on securing effective competition between shippers as a result of existing Bacton capacity holders having less flexibility in using their re-allocated capacity than they currently have (for shippers continuing to hold capacity at Bacton after 1 November 2015 under any of these modifications). This also applies to UNC501V, so we do not consider UNC501AV and UNC501BV to be inferior to UNC501V in this respect. We do consider, however, that the impact of reduced flexibility is minimal as the other market mechanisms referenced above - in conjunction with the availability of substantial amounts of unused capacity at Bacton - mean that shippers can flow flexibly between the two new entry points at low cost in the current regulatory framework.
- Moreover, for the sake of clarity, we do not consider that hand-back addresses the loss in flexibility. This seems better addressed by the existing market mechanisms or a flexibility mechanism similar to what is proposed in UNC501CV.

Regarding UNC501CV:

- We consider that the same negative consequences of capacity hand-back of UNC501CV apply as for UNC501AV and UNC501BV, and hence we consider that UNC501V furthers the relevant objectives more in this respect.
- Set against that, we consider that UNC501CV, when compared with UNC501V, marginally better facilitates the relevant objective of securing of effective competition between shippers. This is because the aggregate overrun mechanism would be a means of re-establishing the flexibility that existing Bacton capacity holders have to enter the NTS from any supply source. However, as a corollary of the points made above, we consider that, in the current regulatory environment, the beneficial impact of avoiding reduced flexibility via this mechanism is minimal, given the availability of other market mechanisms.
- Furthermore, we consider that the rebate mechanism under UNC501CV would be detrimental to competition between existing Bacton capacity holders and other shippers as it would increase the rights of existing Bacton capacity holders beyond what they currently have.
- We hence consider that UNC501V furthers the relevant objectives more than UNC501CV when the above factors are weighed up in aggregate.

We recognise that there may be some impact from the introduction of CAM by splitting Bacton and implementing UNC501V, and that this impact is likely to be concentrated on those holding existing capacity at Bacton. However, we consider that, on balance, these

parties are in a position to mitigate any potential loss through other market mechanisms. We consider that the availability of these other market mechanisms mean that shippers holding long term capacity are still able to derive an economic interest from that capacity or buy capacity that they may need at zero reserve price auctions.

In reaching our decision we have taken into account the possibility of future regulatory changes in this area. However, we consider these changes to be too uncertain to carry substantial weight in the selection of the preferred recommendation and the gas transporter licence requires that we make our decisions based against the current UNC text.<sup>24</sup> Nonetheless, we note the possibility that future UNC changes could remove the option for existing Bacton capacity holders to use the existing market mechanisms (as referred to above) to flow flexibly. In this context, shippers may also want to minimise the risks of future UNC change by developing a flexibility mechanism in a separate modification. This is set out further in the 'next steps' section below.

We are not convinced that the forward-looking competitive position of those shippers with existing capacity rights will be significantly weakened by the introduction of a modification that does not include hand-back. The introduction of a modification which includes hand-back would likely lead to increased costs for all shippers flowing gas onto the NTS because NGG would have to recover the shortfall in payments that would otherwise have been obtained under existing capacity contracts. Further, we consider that it would be inappropriate to approve a modification that introduces rights that are not envisaged in the original capacity contracts, ie, the ability to hand-back capacity. It is fair for existing capacity holders to be exposed to the risks associated with their decision to buy long term capacity.

We explain in more detail our reasoning below, along with some of the views from the responses to the industry consultations and Ofgem IA, and our responses to those views.<sup>25</sup>

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

All four modification proposals facilitate the reallocation of existing Bacton entry capacity rights to one of the two new entry points at Bacton. This will allow existing Bacton capacity holders to continue to use their capacity to flow gas following the split of Bacton on 1 November 2015. Without these modifications, shippers would not be able to flow at Bacton IP or Bacton UKCS after 1 November 2015. We recognise that each of the modification proposals carries with it some benefit for achieving Relevant Objective (a) as each would allow existing Bacton capacity holders to continue to flow gas physically on to the NTS. However, on balance we consider that UNC501V better facilitates this objective, particularly given the negative features of modification proposals UNC501AV, UNC501BV and UNC501CV. We discuss this further below.

When deciding to buy NTS entry capacity, shippers do so in a world of uncertainty and risk. They have to weigh up the benefits of buying capacity in the long-term (such as certainty of rights to flow onto the NTS at a price that is agreed at auction) against the risks (for example, that they will not need all the capacity they bought, including when due to delays/ cancellations in projects or changes in economic conditions). They must

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<sup>24</sup> See Standard Special Condition A11 paragraph 15(b)(i) of the gas transporter licence. See footnote 22 for a link.

<sup>25</sup> The remaining main themes from the responses to the industry consultation and Ofgem's IA are included in Annex 2 to this letter.

also weigh up the benefits of buying capacity in the short term (such as the ability to buy capacity at zero reserve price auctions) against the risk that capacity may not be available. The 'user commitment' principle means that, when shippers book capacity, they commit to NGG that they will pay capacity charges to NGG on condition that NGG commits to making capacity available to them. This has been the key principle in the use of long-term auctions since they were introduced in 2003 so that NGG can plan and develop the NTS based on firm user commitment rather than centralised planning (where the risk of stranded assets would be underwritten by consumers).

The possibility of shippers handing back capacity to NGG to relieve themselves of the financial commitment they have made to NGG (in return for NGG ensuring that they have the right to flow onto the NTS) undermines this user commitment principle. We consider that it is fair for shippers to be exposed to the risks associated with their decision to buy capacity in the long-term. Hand-back of capacity would therefore imply a re-allocation of these long-term capacity risks from current capacity-holders at Bacton to all other NTS users. In our view, it would distort the economic and efficient operation of the NTS if NGG were provided with long-run financial commitments on the use of the NTS which were then removed. Since the IA we have further developed our thinking in this regard and include this as another impact of hand-back. We consider the negative impact on the economic and efficient use of the NTS is largest for UNC501AV, followed by UNC501CV and UNC501BV due to the size of potential hand-back, with no negative impact from UNC501V on this objective.

We note that a theme from some responses to the IA was that any forced reallocation of existing entry capacity rights at Bacton to one of the two new entry points (under UNC501V) would undermine the user commitment model. We do not consider this to be the case. We note that the commitment from NGG was to provide entry capacity at Bacton. The reallocation process will result in NGG continuing to provide entry capacity at Bacton, though on a split basis (ie, either via UKCS entry terminals or via one of the two interconnectors). Therefore, while the reallocation process will result in less flexibility to flow at Bacton for those existing capacity holders, that capacity can still be utilised. By contrast, for the reasons set out above, we do consider that the user commitment model is greatly undermined by the possibility to hand back capacity.

We noted in our IA that another impact of the ability to hand back capacity under UNC501AV, UNC501BV and UNC501CV is that, other things being equal, NGG will have to increase the TO entry commodity charge that all users pay for each unit of gas they flow onto the NTS<sup>26</sup>. A theme from the responses to the IA was that the highest modelled average TO entry commodity charge increase of 2.7% (in the case of 100% return of capacity) was negligible, especially given significant recent increases in TO commodity charges. However, we also noted in the IA that, for UNC501AV, the average increase in TO entry commodity charge was 2.7% each year over a ten year period. This amounts to a total figure of £113m in higher TO entry commodity charges. We do not consider that this impact is negligible. Furthermore, we need to account for all impacts on the UNC relevant objectives when making our decisions, regardless of their size in relation to historical changes. In this particular case, where there are alternative proposals, we also need to assess the impact on TO commodity charges of each proposed UNC modification relative to the others.

In assessing the impact of higher TO entry commodity charges on the economic and efficient operation of the NTS, we note after considering responses to the IA that, at the

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<sup>26</sup> Note that storage users do not pay commodity charges.



margin, they would reduce the arbitrage opportunities for shippers with gas in Belgium and the Netherlands to flow to GB (compared with other neighbouring markets on the continent), all other things being equal.<sup>27</sup> This negative impact on the efficient and economic use of the NTS is greatest for UNC501AV followed by UNC501CV and then UNC501BV due to the size of potential hand-back, with no negative impact from UNC501V.

One respondent to the IA asked for scenario-based modelling. We note that our IA showed the impacts on the TO entry commodity charge from different levels of capacity being handed back. The IA showed the impact on TO commodity charges from different proportions of hand-back: no capacity is handed back (UNC501V), 25%, 50%, 72.77% (UNC501CV) and 100% (UNC501AV). Further, given the uncertainty on the outcome of the European Network Code on harmonised transmission tariff structures for gas (TAR)<sup>28</sup>, and the Gas Transmission Charging Review (GTCR) that Ofgem is currently undertaking<sup>29</sup> we did not think that further scenarios relating to the outcomes of these policy initiatives would add anything material to our analysis. Finally, we note the requirement of the gas transporter licence to consider proposed modifications to the UNC against the status quo, namely the current UNC text.

A further theme from the responses to the IA was that, in the event there was no possibility to either (i) return all capacity, or (ii) have some degree of capacity return along with the ability to use any retained capacity flexibly, then there would be a lack of incentives for shippers to invest in network capacity at Bacton IP and Bacton UKCS and that long term capacity bookings would diminish.

As pointed out in our IA, flexibility has decreased with the implementation of CAM via splitting of the Bacton entry point; this change could be a factor in discouraging long-term investments in network capacity, all else being held equal. However, we note that the possibility to hand back capacity would increase the TO commodity charges and could act as a similar disincentive. Overall, our view is that there will be many factors that are considered as part of shippers' future investment decisions and that allowing capacity return or not, or how flexibly that capacity can be used, will not necessarily be the defining factor. Furthermore, the current market environment for gas is such that long-term capacity bookings are already low and the implementation of CAM is a one-off event, so we consider the impact would be low overall.<sup>30</sup>

Overall, UNC501V has the greatest positive impact for relevant objective (a) against the counterfactual of doing nothing. We note that all four modification proposals confer the general benefit of allowing existing capacity to be used at whichever of the new entry points a shipper reallocates their capacity to. However, UNC501V does not have any of

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<sup>27</sup> Where network entry charges to the NTS increase, via the TO commodity charge, they may make uneconomic some potential flows of gas that could occur to take advantage of the difference in GB and continental gas prices.

<sup>28</sup> The European Commission, the Agency for Co-operation of Energy Regulators (ACER) and the European Network of Transmission System Operators for Gas (ENTSOG) are currently working on the network code on harmonised transmission tariff structures for gas. ACER developed Framework Guidelines on harmonised transmission tariff structures for gas (TAR), see [http://www.acer.europa.eu/Official\\_documents/Acts\\_of\\_the\\_Agency/Framework\\_Guidelines/Framework%20Guidelines/Framework%20Guidelines%20on%20Harmonised%20Gas%20Transmission%20Tariff%20Structures.pdf](http://www.acer.europa.eu/Official_documents/Acts_of_the_Agency/Framework_Guidelines/Framework%20Guidelines/Framework%20Guidelines%20on%20Harmonised%20Gas%20Transmission%20Tariff%20Structures.pdf). ENTSOG then used the Framework Guidelines to draft the network code for TAR, see <http://www.entsog.eu/publications/tariffs>. The Commission has yet to finalise the TAR text.

<sup>29</sup> See Ofgem website <https://www.ofgem.gov.uk/gas/transmission-networks/gas-transmission-charging-review>.

<sup>30</sup> Total demand for gas in GB has declined by 16% since 2010. See DUKES <https://www.gov.uk/government/collections/gas-statistics>.

the negative impacts from hand-back that the other three modification proposals would entail. All other impacts on relevant objective (a) are considered to be marginal.

***(b) so far as is consistent with sub-paragraph (a), the coordinated, efficient and economic operation of (i) the combined pipe-line system, and/ or (ii) the pipe-line system of one or more other relevant gas transporters***

We note that the proposers of UNC501AV, UNC501BV and UNC501CV consider that these modification proposals facilitate relevant objective (b). This is mainly through hand-back allowing for the timely bundling of capacity with the two interconnectors and the reduction of capacity held by users that they do not wish to use. The current definition of 'relevant gas transporters' does not include the interconnectors.<sup>31</sup> Therefore we do not consider this relevant objective to be furthered by any of the modification proposals.

Further, we consider that there are other means to bundle capacity in a timely manner with the interconnectors. These include the voluntary bundling mechanism that NGG has introduced as a result of Ofgem approving UNC500, the ability to surrender capacity (that could then be offered as a bundled product) or trade capacity on the secondary market (which could then be voluntarily bundled by the new holder of that capacity using the voluntary bundling mechanism implemented through UNC500). Furthermore, there are the various congestion management procedures that have been implemented to offer unused capacity to the market.

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

The proposers of UNC501AV, UNC501BV and UNC501CV cite similar arguments as for relevant objective (b) above. These are that hand-back allows for the timely bundling of capacity with the two interconnectors and reduction of capacity held by users that they do not use. We note that FMR considers that there is no impact on this relevant objective from the four modification proposals. As noted above there are other means to bundle capacity and congestion management procedures in place to deal with unused capacity. Therefore we agree with the FMR that there is no impact on this relevant objective from the four modification proposals in this regard.

***(d) so far as 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 (who have entered into transportation arrangements with other relevant gas transporters) and relevant shippers***

Before the Bacton split, existing Bacton capacity holders could flow gas onto the NTS from three main sources (from UKCS, BBL and IUK). Following the implementation of CAM via the splitting of Bacton into two new entry points, the implementation of any of UNC501V, UNC501AV or UNC501BV would result in a reduction in flexibility at Bacton for those shippers that continue to hold capacity at Bacton after 1 November 2015. Shippers holding Bacton IP capacity would only be able to use it to flow onto the NTS from IUK or BBL (and not from UKCS). If those shippers wanted to flow onto the NTS from UKCS, they would need to buy Bacton UKCS capacity. Similarly, shippers holding Bacton UKCS

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<sup>31</sup> This is defined in standard special condition A3(1) of the gas transporter licence as 'a gas transporter who is a DN operator or an NTS operator'. For a link see footnote 22.

capacity would only be able to flow from UKCS (and not from BBL or IUK). If they wanted to flow onto the NTS from either of the two interconnectors they would need to buy Bacton IP capacity.

In our IA, we stated that, currently, with large amounts of unused capacity at Bacton, there was a very high likelihood that shippers that had their capacity reallocated to one of the two new entry points at Bacton could, under the existing charging arrangements, buy within-day or interruptible capacity at the other new entry point at an auction with a zero reserve price. Therefore the outcome is similar to having the current flexibility that existing shippers have, ie no extra capacity charges to flow from all sources of gas arriving at Bacton. We did not receive any evidence to suggest that this is not currently possible given the current UNC provisions on charging and large amounts of unused capacity at Bacton. Therefore we do not consider that implementing CAM by splitting Bacton and reallocating existing capacity in line with UNC501V leads to significant flexibility (and therefore financial) loss to existing capacity holders under the current UNC provisions.

Some respondents to our IA, however, said that the availability of capacity at a zero reserve price may not be possible in the future regulatory world and referred to TAR and the GTCR. The final TAR text is still in development and we have not made a final decision on GTCR.<sup>32</sup> In making a decision on UNC modification proposals we assess the changes against the current UNC baseline. This currently requires zero reserve prices to be used at interruptible and within-day firm entry capacity auctions.

Some respondents noted the current version of the TAR text refers to the possibility to 'grandfather' rights for existing contracts. Firstly, we note that the 'grandfathering provision' was not included in the ACER Framework Guidelines and ACER has requested its removal in its Reasoned Opinion. What will be in a final TAR remains highly uncertain. Secondly, even if the final TAR text does have the possibility to 'grandfather' rights, it is important to note that this refers to transmission charging, and is unrelated to the capacity allocation provisions of CAM. Given that the UNC modification proposals under consideration are for the implementation of CAM, then possible charging-related developments in TAR have no bearing on our decision.

We acknowledge that further potential changes to the UNC are possible. However, such changes are a feature of the UNC and we cannot quantify the probability of future legislative / regulatory changes – including at European level – when making this decision, and any attempt to rely on uncertain future events is too speculative. If groups within industry are concerned that capacity will no longer be available at zero price in the short-term timeframe, and that this represents a risk of reduced flexibility for existing capacity holders, then we would encourage industry to develop a flexibility mechanism similar to the one that is proposed in UNC501CV (whilst addressing our concerns with this proposal as set out below). We discuss this further in the next steps section below. We note that one of the concerns from industry with the implementation of CAM at Bacton was the loss of flexibility in their capacity product.

We note that the UNC describes NTS entry capacity as "capacity in the NTS which a User is treated as utilising in delivering gas to the NTS (and the Total System) at that point".<sup>33</sup>

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<sup>32</sup> Our December 2014 policy position stated that future charging arrangements should be improved by making the reserve price discount on short-term capacity products less than 100% of the long-term capacity reserve price, as the current level of discount is not sustainable. Consequently the UNC has not been changed and still has 100% discounts for short-term capacity products.

<sup>33</sup> See UNC Section B.1.2.3(a) at [www.gasgovernance.co.uk](http://www.gasgovernance.co.uk).

This does not in itself guarantee the right to use any Bacton entry capacity booked before the split in a flexible manner (ie fungibly between the three main sources of gas) on an ongoing basis. Options for flow at entry points tend to change over time. For example, when the BBL interconnector started to flow gas into Bacton in 2006, the flexibility available to those shippers that had booked Bacton capacity pre-2006 increased as a result, but without any change to their contractual agreements with NGG. Conversely, if one of the sources of gas into Bacton decided to discontinue flows into Bacton then the flexibility for Bacton shippers could similarly reduce.

In our IA we also noted that the rebate as proposed in UNC501CV would give existing Bacton capacity holders more rights than they currently have. The rebate would give existing Bacton capacity holders that reallocate their capacity to one of the two new entry points the ability to buy entry capacity at the other entry point and then have options to flow over both new entry points up to the maximum volume of capacity held. If they did not use these options to flow fully on the day, and the capacity they know they would not use is not re-offered to the market, they could still get a rebate for some of the capacity they did not use. This would put existing Bacton capacity holders in a better position from UNC501CV than they currently are compared with other shippers and therefore could be considered detrimental to effective competition between shippers.

Our IA noted that the proposal to hand back capacity in UNC501AV, UNC501BV and UNC501CV would increase the TO commodity charge. This has two impacts. First, as the TO commodity charge is a flat rate for all entry flows onto the NTS, it is not a variable where shippers are able to compete with one another. This differs from capacity charges, where shippers can develop strategies to buy capacity at different locations or times which gives them choice and certainty of holding firm capacity to transport their gas to the market. If a greater proportion of NGG's allowed revenue is recovered via TO commodity charges (as a result of hand-back) then we considered in the IA that this may reduce the possibility for effective competition between shippers. Second, hand-back results in existing capacity holders potentially reducing their overall cost to flow the same amount of gas (as capacity can be bought at zero reserve price auctions) whilst the cost is picked up by other shippers (via the TO commodity charge). This could confer a relative competitive advantage for a few shippers and reduce competition in the gas market. However, following responses to the IA we have reconsidered the impact of hand-back on competition in this respect. We now consider that the impact of capacity hand-back on changes to TO commodity charges would be relatively small in the context of larger increases in TO commodity charge (relative to their current values) that have been seen historically.

Further, we do not consider that hand-back addresses the loss in flexibility described above. This seems better addressed by the existing market mechanisms or a flexibility mechanism similar to what is proposed in UNC501CV.

Overall, the impacts on relevant objective (d) are marginal for each of the four modification proposals. They are negative for UNC501V, UNC501AV and UNC501BV as a result of reduced flexibility (for those shippers that continue to hold capacity at Bacton after 1 November 2015) but the size of this effect is minimal due to the other market mechanisms currently available. The impact of the hand-back on relevant objective (d) are marginally negative for UNC501AV, UNC501BV and UNC501CV (ie, in terms of impact on competition). Whilst for UNC501CV there is a marginal benefit due to the re-creation of the current flexibility to flow at current cost; however, this is reduced due to the issues with the rebate mechanism.

***(g) compliance with the Regulation and any relevant legally binding decisions of the European Commission and/or the Agency for the Co-operation of Energy Regulators***

All four modifications allow NGG to know how much capacity will be available to offer at Bacton IP on EU wide auction platforms. Therefore all four modification proposals further this objective to comply with the CAM Regulation.

**Principal Objective**

The Authority's principal objective is to protect the interests of existing and future consumers, wherever appropriate by promoting competition, We also have a duty (amongst others) to carry out our functions in the manner best calculated to promote efficiency and economy. The Authority must also carry out its functions in the manner that it considers is best calculated to implement, or to ensure compliance with, any binding decision of the Agency or the European Commission made under the Gas Directive, the Gas Regulation or the Agency Regulation in relation to gas. We note that CAM is a European Regulation binding in its entirety and directly applicable from 1 November 2015.

We consider UNC501V is consistent with the Authority's principal objective. Taking into account our own analysis and all the information we have received and carefully considered in response to our IA, we note that there will be no direct impact on consumer bills as a result of implementing the proposal.

**Decision notice**

In accordance with Standard Special Condition A11 of the Gas Transporters' licence, the Authority hereby directs that modification proposal UNC501V: *'Treatment of Existing Entry Capacity Rights at the Bacton ASEP to comply with EU Capacity Regulations'* be made.

**Next Steps**

We recognise that existing Bacton capacity holders attach importance to the flexibility that they had as a result of both UKCS and interconnector flows entering the NTS at that point prior to Bacton being split. We also recognise that a mechanism to maintain this flexibility is not part of the proposal which we consider to best facilitate the relevant objectives, ie, UNC501V. As set out above, we consider that there are existing market mechanisms<sup>34</sup> in the current UNC text which, when combined with the availability of substantial amounts of unused capacity at Bacton, minimise the downside of UNC501V not providing such a flexibility mechanism.

Therefore the benefit to existing Bacton entry capacity holders of a flexibility mechanism, in terms of minimising the impact of CAM implementation on their costs and ability to compete, is currently low when we assess the modification proposals against the current provisions of the UNC (as required by the gas transporter licence).

However, we recognise the possibility that future UNC changes could remove these existing market mechanisms. If such changes to the UNC occurred, then there could be benefits for existing Bacton entry capacity holders and a furthering of effective

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<sup>34</sup> See footnote 19.

competition between shippers from a flexibility mechanism similar to the one that is proposed under UNC501CV (whilst addressing our concerns with this proposal as set out previously). We therefore encourage industry to raise a further modification if they see a risk that future UNC changes would not allow for the existing market mechanisms to be used to flow flexibly at the current cost.

**Paul Branston**

**Associate Partner, Gas Networks**

Signed on behalf of the Authority and authorised for that purpose

## **Annex I: Background and aims of CAM**

The final report of the European Commission's sector inquiry into competition in gas and electricity markets (published in January 2007) noted (amongst other things) the lack of effective competition in European markets.<sup>35</sup>

In response, a suite of legally binding European Union (EU) legislation, referred to as the Third Package, on European electricity and gas markets was introduced and adopted on 13 July 2009.<sup>36</sup> The Third Package was transposed into law in GB by regulations that came into force on 10 November 2011.

The Third Package creates a new legal framework to promote cross-border trade. It requires a number of legally binding Guidelines and 'Network Codes' to be established and implemented.<sup>37</sup> Taken together, these aim to promote liquidity, improve integration between Member States' gas markets and promote the efficient use of interconnectors to ensure that gas flows according to price signals, ie, to where it is valued most.<sup>38</sup> These EU legislative requirements take priority over GB domestic legislation and associated regulations and codes, including the UNC.

The relevant European Network Code (ENC) to this decision is CAM. CAM was published in the OJEU on 15 October 2013 and applies from 1 November 2015. CAM aims to facilitate equal and transparent access to transmission capacity, achieve effective competition on the wholesale gas market, facilitate a more transparent, efficient and non-discriminatory system of allocation of capacity and avoid foreclosure of downstream supply markets. It does this by introducing standard capacity products (in terms of duration), auctions of bundled capacity products at IPs via a cross-border web-based booking system and coordination of maintenance of pipelines or parts of transmission networks by Transmission System Operators (TSOs) and communication procedures by TSOs.

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<sup>35</sup> Inquiry pursuant to Article 17 of Regulation (EC) No 1/2003 into the European gas and electricity sectors (Final Report): [http://ec.europa.eu/competition/sectors/energy/2005\\_inquiry/index\\_en.html](http://ec.europa.eu/competition/sectors/energy/2005_inquiry/index_en.html).

<sup>36</sup> In relation to gas, the Third Package includes Directive 2009/73/EC of the European Parliament and of the Council of 13 July 2009 concerning common rules for the internal market in natural gas and repealing Directive 2003/55/EC (the "Gas Directive") and 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 (the "Gas Regulation").

<sup>37</sup> See Article 6 (Establishment of network codes) of the Gas Regulation which sets out the process for establishing EU-wide network codes for gas.

<sup>38</sup> See Article 8(6) of the Gas Regulation for the areas required to be covered by network codes.

## **Annex II: Main themes from responses to the industry consultation and Ofgem IA not covered in main letter**

This annex sets out some of the main themes from the responses to the industry consultation and Ofgem's IA which are not covered in the reasons for our decision section as they do not easily fit in with the UNC relevant objectives, which that section addresses.

One theme from responses to our IA was that the recent sale of long-term capacity on IUK meant that the analysis in the IA that shippers that buy capacity in the short-term to minimise costs is not accurate. We note that IUK do not offer short-term capacity at an auction with zero reserve price and in their recent sales of long-term capacity offered incentives on quantities booked for five years or more. Therefore the incentives on IUK and NGG capacity pricing are different.

Another theme from responses to our IA was that Ofgem did not include the costs of training that shippers will incur as a result of the new processes at Bacton. We note that this is a consequence of CAM in general and not specific to any of the UNC modifications considered in this decision letter.

Some respondents to our IA noted that Bacton was split such that baseline capacity went to the Bacton IP to meet the technical capacities of the two interconnectors without a financial signal which provides a competitive advantage to users at the Bacton IP. In our decision to split Bacton we noted that the split in baseline at Bacton was in accordance with article 6(1) of CAM which required that the maximum technical capacity is made available at IPs (subject to system integrity, safety and network operation).

One response to the industry consultation noted that any protection from substitution enjoyed by Bacton IP users would enhance the competitive advantage that they perceived was given to such users by UNC501V and compounds the erosion of current long term capacity bookings. They also noted that under the new PARCA regime for booking incremental entry capacity there is a mismatch between capacity products offered on GB auctions at Bacton UKCS and CAM compliant auctions at Bacton IP which may make buying capacity at ad hoc auctions to prevent substitution difficult. The issue of substitution is dealt with in NGG's entry capacity substitution (ECS) methodology statement (MS). In our decision letter to UNC500<sup>39</sup> we noted that we anticipate NGG, after consultation with industry, submitting its ECS MS so that it aligns with the changes made to the UNC as a result of UNC500. These are other aspects that NGG will need to consider when reviewing its ECS MS.

Another theme from responses to our IA was that shippers that want to flow flexibly may need to buy interconnector capacity and are concerned that interruptible capacity on interconnectors will only be made available when firm capacity has sold out. Regardless of whichever modification is approved, existing Bacton capacity holders need to ensure that they have corresponding IUK or BBL capacity if they want to flow via Bacton IP. This is the same as the current situation they face and so not relevant for consideration as part of this decision.

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<sup>39</sup> See

[http://www.gasgovernance.co.uk/sites/default/files/UNC%20500%20and%20UNC%20493%20decision%20letter-1\\_0.pdf](http://www.gasgovernance.co.uk/sites/default/files/UNC%20500%20and%20UNC%20493%20decision%20letter-1_0.pdf).



Another point made in the responses was that Ofgem did not consider the impact of the South North Sea (SNS) producers. As they would use the Bacton UKCS entry point to flow gas onto the NTS we consider that they are considered as part of the Bacton UKCS users and impacts on them.

One point made in the responses to the industry consultation was that the NTS enduring exit capacity product has been end-dated as it is not a CAM compliant capacity product whilst quarterly NTS entry capacity that is held for periods more than one year in advance are also not CAM compliant. They thought that as the quarterly capacity products may be needed at the other side of the IP by a shipper wanting to flow, then such a shipper will not be able to buy this until a year in advance (due to the CAM rules) and so this justifies capacity hand-back. We consider these to be separate issues. Without an end-date to the NTS enduring exit product then this could effectively mean that CAM would not be implemented on NTS exit capacity until shippers reduced all their NTS enduring capacity holdings to zero (which is dependent on shippers doing this). However, the existing sale of quarterly entry products on the NTS is still compatible with implementing CAM.