

OFGEM DECISION LETTER No. 0539

"Changes to Capacity Neutrality to enable Implementation of Final SO Incentive Proposals"
Version 1.0

Transco, Shippers and Other Interested Parties

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Dear Colleague,

Modification Proposal 0539: 'Changes to Capacity Neutrality to Enable Implementation of the Final SO Incentive Proposals'

Ofgem has considered the issues raised in Modification Proposal 0539, '*Changes to Capacity Neutrality to Enable Implementation of the Final SO Incentive Proposals*'.

Transco raised this proposal on 5 March 2002 and requested that Ofgem grant it urgency status. Ofgem agreed that the proposal merited urgency status in a letter issued on 7 March 2002, after which Transco issued the proposal for consultation. Transco undertook to provide a copy of the final modification report to Ofgem on 22 March 2002. Ofgem received the final modification report on 25 March 2002.

Before proceeding to confirm the decision that Ofgem has reached in respect of this modification proposal, Ofgem considers that it is appropriate to clarify some matters surrounding the modification proposal.

Ofgem is concerned to note that some respondents raised the issue that this modification proposal sought to prematurely anticipate the outcome of the statutory consultation process under section 23 of the Gas Act 1986 to introduce changes to the Gas Transporter's (GT) licence of Transco associated with Transco's price control for the period of April 2002-7. Transco sought to address this perception by noting in its final modification report issued on 25 March 2002 that the proposed licence amendments in respect of the System Operator (SO) incentive final proposals are to be the subject of a separate statutory consultation under section 23 of the Gas Act 1986 that has yet to be commenced and that no assumptions can be made in respect of the outcome of this process. While this is correct, Ofgem wishes to address any concerns that industry may have on this matter.

Any decision placed before the Authority under standard condition 9 (Network Code) has to be assessed against the criteria set out therein having regard to the Authority's and the licensee's general duties and all relevant facts. In essence in respect of this modification proposal this means that it has to be assessed against the background of the licence and the network code as they exist today - not as they may be in the future as a result of a consultation process which has not yet commenced. There are circumstances where it may be appropriate to have regard to imminent changes to a licence or regulatory regime in order to assess whether the

changes meets the relevant criteria. Here it is appropriate to note the existence of the Transco SO Incentives Final Proposals but is inappropriate to make assumptions about how these could be translated into licence obligations as these have yet to be consulted upon.

However, Ofgem considers it appropriate to confirm that it does intend to publish licence modifications for statutory consultation under section 23 of the Gas Act 1986 and that one possible consequence of that statutory consultation process is that further changes to Transco's Network Code **may** be necessary to implement changes to Transco price control (Transmission Asset Owner (TO) and SO) for the period 2002-07. Ofgem intends to commence this process shortly. It is important to stress that nothing in this decision nor any other document precludes any signatory to the network code raising modifications on this or any other matter in the future.

In reaching its decision on whether this modification proposal meets the criteria set out in standard condition 9 of Transco's GT licence, Ofgem has noted that Transco has stated that the rationale behind the decision is to facilitate the implementation of the SO Final Proposals. This is not possible for the reasons stated above. Transco have tried to address this matter in its final modification report. The basis for considering whether to direct that the modification be made is set out in standard condition 9 of Transco's GT licence. Having regard to the criteria set out there and for the reasons set out in the Ofgem views section of this letter, Ofgem has decided to direct Transco to make this modification.

In this letter, we explain the background to the modification proposal and give the reasons for making our decision.

Background to the proposal

Since September 1999, Transco has conducted auctions for the sale of firm, monthly system entry capacity (MSEC) to the National Transmission System (NTS). These auctions provide for the allocation of firm entry capacity to successful bidders. In addition to holding MSEC auctions, Transco makes firm Daily System Entry Capacity (DSEC) available on a day-ahead and within day basis where there is additional capacity availability.

In the event of a constraint at an entry point (when physical capacity is less than capacity sold against which gas is flowing) Transco can reduce capacity availability by either scaling back interruptible capacity or buying back firm capacity until the constraint is relieved.

Capacity incentives

Transco currently has financial incentives that are designed to ensure that Transco manages the costs of any buy-backs by exposing it to a proportion of any buy-back costs incurred. The incentives are also designed to ensure that it releases all physically available entry capacity to market by selling additional capacity day-ahead and within-day.

On 24 August 2001, Ofgem accepted modification Proposal 0488 '*Redesign of Capacity incentive Regime*'. This proposal significantly amended the previous capacity incentive and provided for all of the capacity buy-back costs and all of the incremental sales revenue to accrue to shippers via the capacity neutrality arrangements. The new incentive provided that Transco's performance was measured by a Capacity Incentive Performance Measure (CIPM). This CIPM is based on the magnitude of the net cost of capacity buy-backs and incremental sales

for a month compared to a target level, agreed ex ante, of £60 million over the six month period to 31 March 2002. Where the CIPM is equal to zero (i.e. the actual costs are equal to the target) Transco faces no reward or penalty. Under the incentive, Transco obtains rewards (penalties) when actual costs are lower (higher) than the forecast. The annual caps and collars of +/- £5 million were unchanged from the previous incentive, leading to monthly limits of +/- £416,000.

It is noted that Transco has raised modification proposal 0540, '*Delay of Licence and Effects on Capacity Incentives*'. This proposal provides for a capacity buy-back incentive scheme that is based around an annual target of £35 million for the period April 2002 to March 2003. The proposal provides for an annual cap of £30 million and a collar of £12.5 million. Ofgem has issued a separate decision on this proposal today.

Overrun charges

In order to ensure that shippers have a strong commercial incentive to procure sufficient system entry capacity prior to delivering gas to an entry terminal, shippers face overrun charges for any gas flows in excess of the capacity rights held. Any revenue received by Transco from levying overrun charges is currently treated as price-controlled transportation revenue.

Neutrality

At present, revenues from the sale of DSEC at individual terminals are added to capacity neutrality and are apportioned to shippers on the basis of their individual MSEC holdings at the terminal at which the capacity is released.

To the extent Transco buys back capacity, the costs of these buy-backs are apportioned to shippers via capacity neutrality on the basis of the proportion of all of the individual shippers' MSEC capacity holdings across all ASEPs for that month.

The proposal

This modification proposal provides that revenues from overrun charges paid by shippers to Transco should be counted in Transco's buy-back incentive and consequently should be included in capacity neutrality calculations.

The proposal further provides that any revenue generated from DSEC acquired at the day-ahead stage is excluded from capacity neutrality calculations.

In its modification proposal Transco noted that, to enable the revenue from sales of DSEC acquired at the day ahead stage to count towards TO allowed revenue, a new charge type may be required, which in turn would require a change to the file formats. Transco stated that in order to implement this proposal, the normal notice period required by the UK Link committee would need to be waived.

Respondents' views

Of the nine respondents who commented, the majority offered support for the proposal. Of these respondents, two indicated that their support was based on their view that the proposed treatment of overrun and DSEC revenues should remain permanently in the Network Code.

One respondent commented that it is inappropriate for the current regime to continue, and that the proposal will make the Network Code more representative of the commercial incentives that Transco 'will now be subject to'. Another respondent

stated that the modification would avoid the need for detailed retrospective reconciliations following the amendments to Transco's GT licence.

Another respondent however indicated that it did not accept Transco's assertion that the implementation of this modification would avoid the need for subsequent reconciliation processes when the incentives are introduced via licence changes.

Treatment of revenues from sales of DSEC

One respondent agreed that it is appropriate that the treatment of revenue from DSEC sales before the gas day be counted as TO allowed revenue. This respondent indicated that it had understood that irrespective of when it was sold, revenues from the sale of baseline capacity would be counted as allowed revenue.

However, one respondent stated that all revenue from sales of DSEC should be treated as transportation revenue, with another adding that they had concerns that the proposal would result in Transco being paid twice for delivering baseline capacity on the gas day, as this capacity had been funded through the TO price control.

One respondent indicated that it had understood from Ofgem that revenues associated with daily sales of firm capacity would be treated as part of the buy-back incentive revenue. The respondent suggested that the proposal differed from this.

Treatment of Revenue from Overruns

One respondent supporting the proposal that entry capacity overrun charges should not be treated as transportation revenue, suggested that further debate is required on the methodology for calculating overrun charges.

Another respondent suggested that the buy-back incentive was sufficiently robust and generous without the inclusion of overrun revenues within the performance measure.

Transco's GT Licence

A number of respondents commented on the interaction between the modification proposal and Transco's GT licence. One respondent stated that it was inappropriate to implement a modification to the Network Code based on an anticipated change to Transco's GT licence.

Several respondents raised concerns regarding the delay to the publication of the proposals to modify Transco's GT licence and commented that the uncertainty surrounding Transco's GT licence made it difficult to comment on the modification proposal, citing the uncertain revenue flows as a significant cause of concern. One respondent suggested that this uncertainty was undermining competition between shippers. Another respondent indicated that until the licence proposals are published it was unwilling and unable to comment meaningfully on the proposal.

One respondent referred to the relevant objective of the efficient discharge of Transco's obligations under its licence and indicated in reference to the assessment of this proposal that this objective only referred to its current licence and not to anticipated licence conditions. This respondent recommended that Ofgem and Transco consider rolling over the current price control arrangements to ensure that full consultation can be made on the significant changes being proposed for both Transco's licence and the commercial regime in which shippers operate.

UK Link file formats

Some respondents also raised concerns that the potential changes to UK Link file formats could have significant impacts on their IT systems, with another respondent suggesting that a shortening of the consultation period was unnecessary, as the charge would first appear on invoices issued in May.

Transco's view

Transco states that implementation of this proposal is required to facilitate implementation of the final SO proposals and was raised in anticipation of changes to be proposed by Ofgem through amendments to Transco's GT licence. Against this background and while noting that the proposed licence amendments are to be the subject of consultation under s23 of the Gas Act 1986 and that no assumptions could be made regarding the outcome of that process, Transco stated that the proposal facilitated compliance with the relevant objective of the efficient discharge, by Transco, of its obligations under its GT licence.

Transco has also indicated that it needs to ensure that the regime that is being operated by both Users and Transco reflects the changes indicated by Ofgem in published documents.

In its final modification report, Transco indicates that it does not believe that there is a requirement to change file formats.

Ofgem's view

Under the capacity buy-back incentive implemented following Ofgem's acceptance of modification proposal 0540, Transco will receive revenues, or face costs depending on its performance against the target that has been set.

Shippers who are incurring overrun charges have failed to secure sufficient entry capacity to cover their gas flows. This may in some circumstances contribute to entry capacity constraints, forcing Transco to incur additional buy-back costs. Accordingly therefore, it is consistent to treat revenues from overrun charges within the buy-back incentive as the revenue from overruns should offset some of the additional costs incurred by Transco as a result of addressing any overruns at constrained terminals. In this respect, Ofgem considers that this modification proposal better facilitates the efficient and economic operation of the pipeline system by Transco to the extent that the proposal ensures that Transco's capacity incentive is kept active within its collar in circumstances where Transco may be incurring or may have incurred significant buy-back costs associated with shipper capacity overruns.

Ofgem notes that Transco does not anticipate making any changes to the UK Link file formats to implement this proposal.

Ofgem does not accept the position outlined by Transco in its final modification report that the changes proposed in this modification would facilitate compliance with the relevant objective of the efficient discharge of Transco's obligations under its GT licence. In particular, Ofgem considers that it is not possible to determine whether the modification better facilitates this objective in circumstances when the proposed modifications to Transco's licence are to be the subject of a consultation that has not yet occurred.

As outlined previously Ofgem intends to issue the consultation on the proposed modifications to Transco's GT licence shortly. Any modifications to Transco's GT licence are therefore subject to this consultation process. Accordingly, it is incorrect to assume that such changes will be implemented and to judge this proposal against Transco's 'anticipated' licence obligations.

As noted previously, any decision placed before the Authority under standard condition 9 (network code) has to be assessed against the criteria set out therein having regard to the Authority's and the licensee's general duties and all relevant facts. In essence, in respect of this modification proposal this means that it has to be assessed against the background of the licence and the network code as they exist today, not as they may be in the future as a result of a consultation process which has not yet commenced.

Further, as noted above, in reaching its decision on whether this modification proposal meets the criteria set out in standard condition 9 of Transco's GT licence, Ofgem has noted that Transco has stated that the rationale behind the decision is to implement the SO Final Proposals. This is not possible for the reasons stated above. The basis for considering whether to direct that the modification be made is set out in standard condition 9 of Transco's GT licence.

Ofgem's decision

Ofgem has therefore decided to direct Transco to implement this modification proposal, as for the reasons outlined above we consider that it better facilitates the achievement of the relevant objectives as outlined under Standard Condition 9 of Transco's GT licence.

If you have any queries in relation to the issues raised in this letter, please feel free to contact me on the above number.

Yours sincerely,

Mark Feather
Head of New Gas Trading Arrangements