

7021

Direct Dial: 020 7901

16 August 2002

Transco, Shippers and Other Interested Parties

Ref: Net/Cod/Mod/533

Dear Colleague,

Modification Proposal 533 – “Flexibility Improvements to LNG Injection and Capacity Trading”

Ofgem has considered the issues raised in Network Code Modification Proposal 533 “*Flexibility Improvements to LNG Injection and Capacity Trading*” and has decided not to direct Transco to implement the modification because we believe that it does not better facilitate the relevant objectives of Transco’s Network Code. In this letter, we explain the background to the modification proposal, the nature of the proposal and give the reasons for our decision.

Background to the proposal

Transco LNG Storage (TLNGS), a ring-fenced business unit within Transco, owns and operates five LNG facilities. Each facility is connected to the NTS at points that are, or were, at the extremities of the NTS far from beach supplies. The LNG facilities

were not designed to be operated for long periods. At maximum delivery rates, gas in store at the LNG facilities would be exhausted in five days. Injection of gas into the facilities is very slow and typically several months are required to fill and empty LNG facility.

Transco books LNG capacity for emergency system support, ie. operating margins, and for transmission support purposes to ensure that sufficient quantities of gas can be delivered to specific locations. Transco achieves the latter by 'constraining' the way in which shippers deliver a pre-determined percentage of their own gas onto the system from an LNG facility.

Shippers book LNG capacity so that they are able to use stored gas at times of peak demand, ie. 'peak shaving'. In their peak shaving roles, LNG sites are similar to other storage facilities. However, the rapid rate at which stored gas can be delivered (and the associated, relatively short duration for which maximum deliverability can be maintained), coupled with relatively high costs of injection arising from the liquefaction process, implies that the facilities tend to be called into use after other sources of peak gas. In a normal storage year, therefore, a shipper may use only a fraction of its LNG holdings and may hold gas in store at the end of the year.

Each year, shippers book LNG capacity via a pay-as-bid auction held after TLNGS issues its Annual Storage Invitation in March for the forthcoming storage year (after Transco has purchased its LNG requirements). Each unit of LNG capacity that is made available in the auction is made up of injectability, deliverability and space capacity rights. While each bundled unit contains a fixed ratio of space capacity to deliverability (five units of space capacity to one unit of deliverability) that are separately tradable, this is not the case with the injectability rights associated with an LNG booking.

The modification proposal

Modification Proposal 533 puts forward a number of changes to the LNG injection and capacity trading arrangements. They are:

- i) the provision of firm injection capacity rights – at present these rights are bundled with space and not separately transferable;
- ii) the introduction of a clearly defined maximum lead-time for injection nominations of 15 days (although shorter lead times may be notified) – at present injection 'programmes' must be submitted by the 15th day in the previous month;
- iii) the introduction of compensation arrangements when injection was cancelled for more than 15 days in a year at a daily rate equivalent to the imputed annual injection capacity charge divided by 365;
- iv) that LNG Users would be able to trade injection and withdrawal capacity on a part-day basis; and
- v) the introduction of injection overrun charging arrangements that would operate according to a mechanism that would be published in the annual storage invitation.

Respondents' views

Two representations were received in response to the proposal. One of the respondents supported the implementation without reservations, presenting the view that the proposal would help potential users of better determine the value of LNG and that it would encourage subsequent trading of LNG services.

The other respondent also supported the proposal, but requested that consideration be given to two alterations:

- a) the respondent argued that the compensation proposed in respect of the cancellation of injection was insufficient, given that no compensation at all would be paid unless injection was cancelled for more than 15 days at a facility, and that thereafter the proposed compensation seemed very low. The respondent proposed that compensation arrangements should be put in place in relation to

all injection cancellations in the event that the cancellations could have resulted in a customer filling its booked capacity; and

- b) the respondent noted that the proposal envisaged no limit on the injection overrun charge that TLNGS would apply providing only that the levels are declared in the Annual Storage Invitation. The respondent argued that, given that access to over-runs may prove particularly valuable, the ability to set overruns may confer considerable market power. It was concluded that there must be some restraint on the levels of overrun charges that TLNGS are entitled to apply.

Transco's View

Transco argued that the implementation of the modification would improve the flexibility of services offered by TLNGS, and that as a result users would be better placed to attach a value to these services. Transco has argued that these changes would better facilitate the securing of effective competition between relevant shippers.

With respect to the argument that the level of compensation for cancelled injection seemed very low (point (a) above), Transco indicated that it would consider the suggestions made by the respondent in future annual storage invitations, but noted that the levels of compensation proposed exceeded that currently available to LNG users. With respect to the lack of limitation on injection overrun charges (point (b) above), Transco argued that the operation of the market would limit users' exposure to high overrun charges and suggested that this was an issue for consideration in future annual storage invitations.

Ofgem's view

In deciding whether to accept a modification to Transco's Network Code Ofgem must decide whether the modification "better facilitates the relevant objectives" as given in Standard Condition 9 paragraph 1 of the GT licence. Ofgem considers that the most pertinent of these in relation to this modification proposal is 9(1)c which

relates to the securing of effective competition between relevant shippers and between relevant suppliers.

Ofgem considers that the majority of the changes put forward in this modification proposal – in particular, points (i) to (iv) above – can be expected to better facilitate this relevant objective. The current LNG injection arrangements are poorly defined relative to other storage facilities and that the terms offered in relation to injection service cancellation are also poor by comparison. However, as stated above, the test in relation to a Network Code modification concerns whether the modification provides for an improvement in relation to the relevant objectives. Points (i) – (iv) above can be expected to improve contract definition, and in some cases, contract terms, and as such can be expected to better facilitate the securing of effective competition between relevant shippers and between relevant suppliers.

However, Ofgem has significant concerns in relation to point (v) above. Whilst Ofgem clearly welcomes the proposal for better contract definition of injection rights, the fact that the methodology that would be introduced for injection overrun charging is not set out in the modification proposal significantly hinders the making of a proper assessment of whether or not the resulting arrangements would better facilitate the relevant objectives of the Network Code. In effect, such an approach gives TLNGS the freedom to set overrun charges at such a level that might affect the sale of LNG services.

As set out in our recent consultation document on the proposed transfer of the LNG business out of Transco¹, Ofgem considers that provision of Use-It-Or-Lose-It (UIOLI) arrangements at LNG facilities is of considerable importance for the efficient utilisation of facilities. Absent of UIOLI arrangements, overrun arrangements can provide an effective alternative source of flexibility to users. This is very relevant for LNG injection rights, as considerable stocks typically remain in store at the end of a given storage year, and access to unused firm rights can significantly affect the

¹ Transco's proposal to transfer its Liquefied Natural gas facilities to a non-regulated Lattice Group company. A consultation document, Ofgem, July 2002.

likely time to fill booked space capacity. This can be of particular importance to new users.

Without clarity as to how and at what level new overrun charges would be set, Ofgem does not consider that it can conclude that the proposed modification would better facilitate the securing of effective competition between relevant shippers and between relevant suppliers

Ofgem's decision

Ofgem has decided not to direct Transco to implement the modification, because we do not believe that the proposal will better facilitate the relevant objectives of Transco's Network Code.

If you have any queries in relation to the issues raised in this letter, please contact me on the number above or Amrik Bal on 020 7901 7074.

Yours sincerely,

Kyran Hanks
Director, Gas Trading Arrangements