Transco, shippers and other interested parties

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Dear Colleague,

Modification 429 "Section P re-write"

Ofgem has considered the issues raised in modification proposal 429 *'Section P re-write'* and has decided to direct Transco to implement the modification because we believe that it better facilitates the relevant objectives of Transco's Network Code. Ofgem expects that the modification will be implemented with immediate effect.

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

Background

In April 1998, Ofgas launched a detailed investigation into the market for gas storage and related services, and the behaviour of the dominant participants in that market. The main purpose of the review was to collect and assess evidence of the existence and use of market power in the provision of storage services. The review concluded that BG Storage possessed significant market power, at least in the short term, and that it was being exercised in ways that were hindering the development of competition[1].

In September 1998, Ofgas proposed new arrangements for selling capacity at the Rough and Hornsea facilities for the storage year 1999/2000, and for each of the four subsequent storage years. The selling of capacity rights via an auction process was central to Ofgas' proposals regarding the move towards a competitive storage market. Following consultation on the detailed rules, the first auctions were held in March for the storage year 1999/2000.

In June 1999, Ofgem initiated a review of BG plc's five Liquefied Natural Gas (LNG) facilities. BG Transco (as it was then known) uses the LNG facilities for both storage purposes and as a means of overcoming transportation constraints. In the event that shipper bookings at any of the sites do not reach a pre-determined 'monitor level' that allows Transco to fulfil its obligation to meet a 1-in-20 winter peak day demand, Transco is able to act as the 'Top-up Manager' and book the difference, i.e. it purchases 'Top-up' gas.

In our 1998 review of Top-up gas, Ofgas made clear its view that there should be no long-term requirement for Top-up since the GB gas industry is characterised by a diversity of peak supply options[2]. Transco has subsequently argued that there are, in fact, two types of top-up gas, known as 'National Top-up' and 'Constrained Top-up'. National Top-up purchases are used by Transco to help balance national supply and demand imbalances. Constrained Top-up purchases, however, are made by Transco to help overcome local transportation constraints on its system. Ofgem accepted, when conducting the LNG review, that the use of constrained Top-up could be efficient where local storage could effectively be used as a

[1] At the time, BG Storage owned the Rough and Hornsea facilities and operated the five LNG facilities.
[2] Review of Top-up gas. Conclusions. Ofgas, April 1998.

substitute for additional pipeline and where the costs of using storage were lower than the costs of additional investment in pipeline. However, Ofgem's interim LNG arrangements were designed to ensure that shippers would provide Constrained Top-Up with only a residual role for Transco in the event that shippers did not book sufficient capacity at the sites. Ofgem continued to argue that it was inappropriate for Transco to have a role in booking National Top-Up as shippers have strong incentives to balance their own positions each day.

As we have since made clear, this view is especially true of National Top-up purchases. For instance, Ofgem's approval of Modification 0391 *'Treatment of Constrained Top-up costs for 2000 to 2002'* on 14 April 2000, was given on the basis that it allowed for the recovery of Constrained Top-up costs only.

Following consultation and the publication of initial proposals, interim arrangements were agreed in April for the storage year 2000/1, under which Transco agreed to auction capacity at all five LNG sites.

The underlying objective of the storage review and the auction arrangements was to promote a timely transition to a competitive storage market and to prevent the exploitation of market power by BG Storage and Transco in the transition to a competitive storage market. In order to help facilitate the transition to such a market, there were modifications to the Network Code that helped remove the Rough and Hornsea facilities from BG plc's PGT Licence, introduced competition in the storage market, and ring-fenced the five LNG facilities from Transco's transportation business. Clearly, such changes have had implications for Section P of the Network Code, which addressed the operation of the Rough, Hornsea and LNG facilities prior to the deregulation process.

Up to the present date, there have been three such Network Code modifications that have been implemented in parallel with the storage deregulation process as outlined above.

In March 1999, Modification 0310 '*Storage Unbundling*' was implemented. The effect was to remove the Rough and Hornsea facilities from the Network Code. This reflected the fact that the facilities were no longer part of BG plc's then PGT Licence, and were instead owned and operated by BG Storage. In return for the removal of the facilities from its PGT licence, BG plc gave a series of Undertakings regarding the operation of Rough and Hornsea, and the way in which capacity would be made available to the market. This modification also moved the arrangements for the LNG facilities from Section P of the Network Code to Section Z, with minimal changes. The remainder of Section P was left to deal with the issue of top-up gas which is purchased by the Top-up Manager (as outlined above).

Also in March 1999, Modification 0311 '*Operational Use of Storage, Post-unbundling* was implemented. In order to facilitate competition in the provision of storage services, this modification placed the terms on which Transco would deal with any Storage Operator in Section R of the Network Code. It should be noted that Transco also introduced a generic Storage Connection Agreement (SCA) at this time, to ensure consistent connection arrangements between itself and other storage operators. Due to time constraints, however, a detailed review of Section P was not carried out at this stage, so Section P of the Network Code was consistent only with the terms on which the five LNG facilities were used and not any other storage sites, such as Rough and Hornsea.

In September 2000, Modification 0395 '*Removal of Storage Nomination Arrangements*' was implemented. This proposal created the obligation to make separate storage and transportation nominations, and was one of a number of modifications seeking to standardise terms between storage points and other entry / exit points.

As a result of the above modification changes to the Network Code, Section P does not accurately reflect either the introduction of competition or the revised nature of the relationship between Transco, Storage Operators and the Top-up Manager. Transco aims to address this situation with a new Network Code modification that would amend Section P by removing the inconsistencies that now exist as a result of the above modifications.

Proposal

In modification proposal 429, Transco has proposed a series of changes that would address the shortcomings and inconsistencies that currently exist in Section P of the Network Code. In summary, the proposals are:

1. *Correct minor cross referencing errors*

   To remove any ambiguity and misunderstanding which could arise. These cross-references would not materially alter Section P of the Network Code.

2. *Re- introduce a generic definition of facility type*

   Transco argue that much of Section P relies on the definition of particular storage facility types. It is proposed that three storage facility types be defined based on service durations of less than 10 days, less than 30 days but greater than or equal to 10 days and greater than or equal to 30 days.

3. *Top–up Manager should have access to information at the aggregate level for each storage site*

   Section P contemplates that the Top-up Manager will have information on gas stocks in a facility at the individual shipper level. Transco believe this level of detail is in excess of that contemplated by the 'Storage Connection Agreement' (SCA) which requires the storage operator to provide details on stocks at the aggregate level. Transco has stated that it believes that the Top-up Manager is able to fulfil its role adequately with information at the aggregate level.

4. *Allow all stored gas to contribute to monitor levels*

   Transco believes that the introduction of storage competition has led to a requirement to change the definition of which storage bookings the Top-up Manager will use to determine whether or not a Top-up requirement exists both ahead of the year and within year. Transco proposes that it should only consider gas capable of being withdrawn during the winter period as that which should be considered as contributing to the monitor level. This, Transco believes, should include all gas relating to all customers of a storage facility regardless of whether or not they are a User of Transco's system.

5. *Allow surplus Operating (OM) Margins gas to contribute to monitor levels*

For supply security each facility has a monitor level which has to be maintained as well as an aggregate monitor level across all sites. Where a shortfall against this level exists, the Top-up Manager has to take action to arrange for gas to be injected into store. If the Operating Margins' (OM) account is in surplus the Top-up Manager can make a transfer at a price predetermined by the Network Code. Transco argues that since OM and Top-up are funded by different parties, it is better to allow surplus OM gas to be counted towards the monitor level without actually conducting a financial transfer between the Top-up and OM accounts unless the gas is used.

6. *Allow surplus stocks in shorter duration facilities to contribute to the stock levels required in longer duration facilities*

   Sufficient aggregate gas stocks across all sites to meet the aggregate monitor level do not necessarily preclude a deficit of stocks at specific facility types. Current rules require injections to be made into the specific facility in deficit to bring stock levels back up to the site specific monitor level. Transco believes that surplus LNG could act as a substitute for Rough or Hornsea, and Hornsea could substitute for Rough. Transco proposes that surplus stocks in shorter duration facilities should be allowed to contribute to the stock levels required in longer duration facilities.

7. *Review supply security level within year*

   Currently, there is a single date driven event for determining the Top-up requirement for the year. Transco proposes that if new gas storage facilities become available within-year, Transco should be able to review the declared supply security level.

8. *Gas transfers under the terms of late booking*

   This proposal relates to the situation where the Top-up Manager has unfilled Storage Space and a User is registered as holding storage capacity with an application made after the invitation close date. Transco intends that the Top-up Manager will surrender an amount of capacity equal to but not exceeding the amount of unfilled storage space it holds, to the user.

9. *Gas transfers at 105% WACOG*

   Shippers can ask the Top up manager to transfer gas in store to a User at 105% of the Weighted Average Cost of Gas (WACOG). It was envisaged that this price was sufficiently high to discourage Users from asking for a gas transfer and was intended to place incentives on Users to book and fill storage early. However recent market prices have shown that 105% of WACOG has been less than the cost of gas purchased at the National Balancing Point (NBP) plus injection charges. Shippers therefore could benefit from requesting a transfer of gas in store. Transco therefore propose a new mechanism where the pricing of transfers would be 105% of the greater of WACOG or NBP gas plus injection charges of the appropriate facility in which the transfer would take place.

Respondents' views

Three responses were received all expressing support for the modification.

One respondent commented that the implementation should be as soon as possible in order to alleviate pressure over this winter period.

Another respondent commented that it supported the tidying up of the Top-Up rules as an urgent priority. This respondent also said it was satisfied that its comments on the legal drafting have either been incorporated or fully considered.

Other respondents made a number of comments on the legal wording. Transco subsequently amended its legal text to reflect these comments except in one instance:

In particular, these respondents said that with respect to section P4.1.1, it may be appropriate to change the line “any storage User may request the Top-up manager to surrender Storage Space” to “any Transco LNG Storage User may request the Top-up manager to surrender Storage Space”. Transco felt this was unnecessary.

Transco’s views

Transco believes that this modification would correct the inconsistencies within Section P caused by previous modification proposals. In general, these changes would better reflect the changing nature of the storage market, and remove possible sources of confusion when interpreting Section P of the Network Code.

Moreover, in addition to the above, Transco has stated its support for this modification for the specific reason that several elements of it have the potential to decrease the possible generation of Top-up costs.

Ofgem’s views

Ofgem notes that this proposal was the result of an extensive and detailed discussion process within the Planning, Security and Storage Workstream. However, only three shippers responded to the formal proposal, and all were in favour. Ofgem would like to take this opportunity to explain its views on the various elements that go to make up modification 429.

Ofgem welcomes any move that reduces the potential for ambiguity in interpretation of any part of the Network Code. Clearly, therefore, we are in favour of the correction of any minor cross-referencing that currently exist within Section P and which could lead to any misinterpretation.

Ofgem also believes that the re-introduction of a generic definition of facility type to allow Section P to function as originally intended is to be welcomed. Such a generic definition would have the effect of facilitating any proposed changes to the calculation of monitor levels (as discussed below), and so could indirectly contribute to a reduction in potential levels of top-up charges incurred by Transco in its role as Top-up Manager.

Ofgem supports the amending of Section P to the effect that that the Top-up Manager has access to information at the aggregate level, rather than at the individual User level. The reason for Ofgem’s support is that this would ensure that Section P is consistent with the Storage Connection Agreement but would not affect the Top-up Manager’s ability to fulfil its role.

Ofgem believes that enabling a more appropriate method for defining which Storage booking would contribute towards monitor levels could potentially reduce top-up costs, and is thus to be welcomed. By way of explanation, it is no longer the case that only Users of Transco's system have gas held in store. This proposal would allow Non Users' Storage Booking s to contribute towards the monitor level with the understanding that the gas held in store could flow into the system if market conditions were right. Given this potential reduction in Top-up bookings by the Top-up Manager and the associated costs, Ofgem is in favour of this element of the proposal.

Ofgem also believes that the introduction of a mechanism whereby surplus gas in any facility can contribute to a monitor level deficit in a specific facility, provided that the latter is of a longer duration type facility, is to be welcomed. Ofgem considers that this again could reduce the potential for unnecessary and uneconomic Top-up gas purchase by Transco in its role as Top-up Manager.

Ofgem supports a more cost efficient way of allowing surplus Operating Margins' stocks to contribute to the monitor level of the same facility because this again could have the potential to reduce Top-up costs. Current arrangements require a financial transaction at the time of transfer, whilst this element of the modification proposes that such a financial transfer only takes place if the gas is actually used.

Ofgem is also in favour of changing the method of pricing gas transfers to one that better reflects the appropriate cost of gas on the day of the transfer. Ofgem considers that this would provide incentives for shippers to book and fill appropriate levels of capacity, without resorting to an in-store gas transfer at a pre-determined price that is unrealistic given current gas prices at the NBP. This could also lead to a reduction in the generation of unnecessary Top-up costs and for that reason Ofgem welcomes this element of the proposal.

Ofgem would like to make clear that the above views relate to the recovery of Constrained Top-up gas purchases only, not to National Top-up gas purchases. We remain of the view that given the increasing source of peak day gas supplies, there is no requirement for Transco to be making National Top-up gas purchases and recovering the costs of doing so from shippers.

Ofgem's decision

Ofgem has decided to direct Transco to implement this modification because we believe that it better facilitates the relevant objectives outlined in Standard Condition 7 of Transco's Gas Transporter's licence. In particular, Ofgem believes that the proposal would better facilitate the economic and efficient operation of the NTS by making Section P of the Network Code more reflective of, and consistent with, the changes to the storage market.

Ofgem expects Transco to implement this modification immediately.

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

Yours sincerely

Mark Feather
Head of RGTA