

**OFGEM DECISION LETTER No. 0542**  
"Revised Energy Balancing Incentive Arrangements post April 2002"  
Version 1.0

Transco, Shippers and Other Interested Parties

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Dear Colleague,

**Modification Proposal 0542: *'Revised Energy Balancing Incentive Arrangements post April 2002'***

Ofgem has considered the issues raised in Modification Proposal 0542, 'Revised Energy Balancing Incentive Arrangements post April 2002'.

Transco raised this proposal on 13 March 2002 and requested that Ofgem grant it urgent status. Ofgem agreed that the proposal merited urgent status in a letter issued on 13 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 these modification proposals sought to prematurely anticipate the outcome of the statutory consultation process under section 23 of the Gas Act 1986 to introduce changes to Transco's Gas Transporter's (GT) licence associated with Transco's price control for the period April 2002-7. Transco sought to address this perception by noting in its final modification report issued to the industry on 25 March 2002 that the proposed licence amendments in respect of the SO 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 participants may have on this matter including the manner in which Ofgem has reached its decision on this proposal.

Any decision placed before the Authority under standard condition 9 (Network Code) of Transco's GT licence 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 System Operator (SO) Incentive Final Proposals but it 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.

The basis for considering whether to direct that this 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 implement this proposal.

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

## **Background to the proposal**

### *Gas balancing – New Gas Trading Arrangements*

Shippers have commercial incentives under the Network Code to balance their inputs and offtakes of gas to the system each day. Transco undertakes the role of residual system balancer to the extent that shippers do not balance their inputs and offtakes and the system becomes long or short in aggregate over the gas day. As residual system balancer Transco buys and sells gas on the On-the-day-commodity market (OCM) to ensure that the National Transmission System (NTS) remains in balance and that linepack remains within safe operational limits. When linepack is falling (i.e. offtakes exceed inputs) Transco may buy gas. Conversely when system inputs exceed offtakes Transco sells gas to bring the system back into balance.

### *Transco Gas Balancing Incentive*

As part of the introduction of the New Gas Trading Arrangements in October 1999, Transco was provided with incentives to encourage it to undertake its balancing actions efficiently. Under this price-based incentive, Transco received benefits depending on how close the price of Transco's marginal trade was to the system average price (SAP) on the OCM. The incentive applied both to Transco's buy and sell actions. This incentive was introduced following Ofgem's acceptance of Modification Proposal 0313, 'Development of the Energy Balancing Regime to Facilitate implementation of the on-the-day commodity market'. Under the incentive, if Transco's marginal price trade was within 5% of SAP on any day, Transco received a bonus payment, up to a maximum of £2,000, which it received if it traded at the average price. Conversely, Transco was exposed to a daily penalty of up to £15,000 if the differential exceeded 5%. An annual cap and collar of £2 million also applied, that was further divided into monthly caps and collars.

Transco's energy balancing incentive was revised from 1 June 2001 following Ofgem's acceptance of modification proposal 0414, 'Proposal to reform the Transco Energy Incentive Redesign'. This proposal added a linepack parameter to the gas balancing incentive. This followed Ofgem's review of the New Gas Trading Arrangements in July 2000 *The New Gas Trading Arrangements: A review of the new arrangements and further development of the regime: A review and decision document, Ofgem, July 2000*, which identified that the differential between end-of-day and target linepack had been increasing and that Transco had been appearing to be using changes in linepack to balance the system on certain days rather than taking balancing actions. The linepack incentive therefore introduced a linepack target on Transco as part of the daily gas balancing incentive.

The linepack incentive is intended to address the concern that the price incentive alone, by encouraging Transco not to take system balancing actions on a given day but instead to use linepack might lead to mis-targeting of balancing costs from day to day (as Transco was effectively carrying over imbalances from day to day) and could be reducing liquidity on the OCM. In particular, Ofgem considered that the carry over of system imbalances from day to day through the use of system linepack could result in a misallocation of balancing costs between shippers if, for example, a shipper was out of balance on the day when no action was taken but in balance on a subsequent day when action was taken.

Under the current gas balancing incentive implemented through modification 0414 Transco can receive up to £4000 a day, if it minimises the spread between its marginal buy price and marginal sell price. Transco is exposed to a penalty of up to £30 000 a day when the differential between the marginal buy or sell price exceeds 20% of SAP. The linepack parameter provides an incentive for Transco to manage daily changes in linepack discouraging them from carrying over imbalances from day to day. Under this incentive Transco can receive up to £4000 per day if there is no difference between opening and closing linepack. It continues to benefit under the incentive so long as the absolute difference between opening and closing linepack is less than 2.4 mcm. If the difference is greater than 2.4 mcm, it loses money under its incentive up to a daily collar value of £30 000 for a difference of about 20.4 mcm or more.

#### *Recovery of incentive costs and revenues*

The net costs and revenues associated with Transco's gas balancing incentive are currently recovered through the energy neutrality charge. This charge also recovers the net costs associated with buying and selling gas on the OCM, the net costs associated with buying and selling gas to market participants through the cash-out mechanism and the revenue received through the application of scheduling charges.

On 18 January 2002, Ofgem decided not to veto Transco's Pricing Consultation (PC) 70, 'Proposal for NTS System Operation Transportation Charges'. PC70 replaces the NTS standard commodity charge with an SO commodity charge which is to take effect from 1 April 2002 and which will be levied on the basis of exit flows from the NTS. From 1 April 2002 Transco intends to use this charge to recover the payments and rewards associated with its SO incentives.

### **The proposal**

This modification proposal provides for an increase in the maximum incentive amount that Transco can earn for superior performance under both its price and linepack incentives, to

£5,000 per day and to increase both the annual cap and collar under both incentives to £3.5 million.

In addition, the modification proposes that payments and rewards associated with these incentives will not flow into balancing neutrality.

### **Respondents' views**

The majority of respondents supported the proposal, although some qualified their support.

One respondent stated that the modification was necessary to reflect Ofgem's SO proposals and that it would not be appropriate to continue with the current regime, which is not reflective of the more commercial arrangements which Transco will be subject to. However, this respondent expressed concern that these interim arrangements create uncertainty for users and the short time period for consideration introduced risks.

Two respondents, in supporting the proposal, stated that the incentives should remain permanently in the Network Code. One of these respondents added that defining the incentive parameters in the Network Code would give market participants (who fund the incentives) the opportunity to amend the incentives in response to changing market conditions. This respondent believed that the current difficulties in changing Transco's GT licence meant that 'hard-coding' trading arrangements rules into the licence was inflexible and inappropriate.

Some of the respondents were unclear about the treatment of revenue flows associated with the proposal. One respondent also commented that there is still insufficient industry understanding of the interaction with other SO incentive components, the relationship between Transco's SO and TO roles and Transco's trading role.

One respondent considered that there might be a mismatch between the year that the incentive is operational and the recovery of any reward (penalty) via the SO commodity charge, suggesting that there may be a misallocation of costs across users.

Some of the respondents requested clarity on the mechanism by which this proposal would be removed from the Network Code once any proposed licence amendments are implemented. A further consultation on Modification 0519 was suggested by one respondent as a mechanism for removing any modifications implemented under this proposal.

Some of the respondents were concerned that they were being asked to comment on this proposal when they had not yet seen the proposed licence drafting for the Transco price control. One respondent opposing the proposal argued that due process required that until the licence changes and the SO incentives are finalised and accepted the arrangements set out in the proposal cannot be accepted or implemented. Another respondent expressed concern about the processes associated with the implementation of Transco's licence conditions to implement its price control and raised concerns that shippers were being asked to comment on modification proposals required to facilitate the implementation of the price control licence conditions for which participants are yet to see drafting.

One respondent stated that the licence changes should have been finalised by now, and last minute changes to the Network Code would only add confusion and uncertainty. Another respondent felt that it was unacceptable for Transco to seek to introduce changes to the Network Code while it was effectively hedging its own commitment to these changes.

## **Transco's view**

Transco's stated justification for raising this proposal was to give clarity to the residual gas balancing incentive that will apply from 1 April 2002. It also stated that the proposed changes to its incentives may lead to greater residual balancing efficiency which will benefit all market participants. Transco has also indicated that the implementation of this proposal will help to reduce the reconciliation amount subject to the reconciliation process that may otherwise be necessary if the current regime were allowed to continue but was then superseded by amendments introduced retrospectively following revisions to its GT licence.

Transco stated that the proposed licence amendments are to be the subject of a consultation under s23 of the Gas Act 1986 and that no assumption can be made regarding the outcome of that process. However it also stated that the proposal would facilitate compliance with the efficient discharge of its licence obligations.

## **Ofgem's view**

The proposed changes to Transco's residual gas balancing incentive schemes should, in line with Ofgem's final SO proposals, improve its incentives compared to the existing scheme. Ofgem considers that a sharpening of these incentives is appropriate given Transco's increased understanding of the operation of its system under the New Gas Trading Arrangements.

The strengthening of the incentives contained in this proposal, by offering Transco the scope for larger daily and annual upsides and exposing it to higher annual upsides and downsides in the event of poor performance, should better facilitate the economic and efficient operation of Transco's pipe-line system thereby encouraging lower residual gas balancing costs.

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.

## **Ofgem's decision**

Ofgem has therefore decided to direct Transco to implement this modification proposal because, for the reasons outlined above, we consider that it better facilitates the achievements 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**