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Direct Dial: 020

20 June 2003

Shippers, Transco and Other Interested Parties

Our Ref:

Net/Cod/Mod/558

Dear Colleague,

Modification Proposal 558 – “Amendments to Operating Margins Pre-emption Rights at LNG sites”

Ofgem has considered the issues raised in Modification Proposal 558 - *“Amendments to Operating Margins Pre-emption Rights at LNG sites”* - and has decided not to direct Transco to implement the proposal. 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

Transco is required under the network code to produce its Operating Margins' (OM) statement by 1 March every year. This statement contains Transco's estimate of its LNG capacity requirements for the following storage year (beginning 1 May). Transco purchases this LNG capacity at regulated prices, and other LNG Users (mainly but not always licenced shippers) then participate in an auction for the remaining LNG capacity.

If Transco's OM statement indicates an increased requirement for LNG capacity for the next storage year, this reduces the overall capacity available for other LNG Users. This could have a negative impact on the ability of an individual non-Transco LNG User to be able to carry over gas-in-store from one storage year to the next.

In this instance, an affected User would either have to withdraw the gas, sell it in store to another party, or sell it to Transco for OM purposes.

The modification proposal

It is proposed that Transco continues to have 'free pre-emption' rights up to a quantity at any LNG facility which is the greater of:

- i) the amount of OM gas held in that store at 1 March; and
- ii) the capacity at that facility available to all Users for the ensuing storage year less the total quantity of gas held in store in firm bookings at 1 March by LNG Users other than Transco for OM purposes.

The above means that Transco will always have access to either all empty or unbooked capacity, or enough to cover its OM bookings' (if unchanged year on year). However, if this does not result in sufficient LNG capacity for Transco because of an increase in Transco's OM requirements, then Transco should hold a tender inviting other LNG Users to sell bundled capacity rights (for the remainder of the storage year) and the associated gas-in-store.

If other Users decline to participate in such a tender or if it results in insufficient capacity being offered, Transco would then have the right to such additional pre-emption as is required, regardless of the impact on other Users.

Respondents' views

Three responses to this modification proposal were received, with two in favour and one against the proposal.

The comments in favour concentrated on the lessening of Users' risk exposure when Transco increased its OM requirements, thus leaving other Users with insufficient future capacity to cover their remaining gas-in-store. The view expressed was that under this proposal Transco would at least have to pay a market related price for their additional capacity requirements.

Another respondent, however, commented that this proposal could lead to inefficient purchases of LNG services and that Transco should instead be required to contract with other parties directly for the provision of such services.

Transco's Response

Transco did not support the modification proposal as its purchases of LNG services were covered in its System Operator (SO) incentives scheme. Additionally, Transco was surprised that the proposed compensation scheme (to cover Users becoming 'distressed sellers' of gas) did not refer to the Weighted Average Cost of Gas (WACOG) or System Average Price (SAP) as this would have been a better reflection of the costs of the gas-in-store.

Ofgem's view

Ofgem appreciates that Transco's pre-emption rights can result in uncertainty for other LNG Users with respect to the volume of capacity available for the following storage year. However, such Users are presumably aware of the potential implications of having gas-in-store at the end of the storage year in the event that Transco announces an increased need for LNG capacity for the following storage year. In many respects, this situation is no different to having one year capacity rights at any storage facility, having gas-in-store and not being able to secure any or sufficient capacity rights, ie. in an auction, for the following storage year.

It is also unclear as to why this modification attempts to link an increased need on the part of Transco for LNG capacity for the following LNG storage year with the need to purchase LNG capacity and the associated gas-in-store in the current storage year.

Furthermore, it is also Ofgem's view that the potential exposure that this modification seeks to address results from LNG rights being auctioned for a year long period only. If LNG capacity rights were instead sold for a multi year period, LNG Users would not face the exposure they presently face as they would have capacity rights for the following year.

Ofgem's decision

Against this background, Ofgem has decided not to direct Transco to implement this modification. We do not believe that it better facilitates the relevant objectives in 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 number indicated above.

Yours sincerely,

Amrik Bal
Gas Trading Arrangements