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Our Ref: Net/Cod/Mod/681
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30 April 2004

Dear Colleague

Network code modification proposal 0681 "Amendment of Network Entry Provisions at ConocoPhillips sub terminal at Theddlethorpe"

Transco proposed to modify the gas quality parameters in place at ConocoPhillips sub terminal at Theddlethorpe, which are set out in the relevant Network Entry Agreements (NEAs). These parameters included;

- lowering the Wobbe number from 48.3 MJ/m^3 to 47.36 MJ/m^3
- increasing the upper end of the Wobbe number from 51.3 MJ/m^3 to 51.41 MJ/m^3
- increasing the lower limit of the calorific value from 36.9 MJ/m^3 to 37.3 MJ/m^3
- aligning the hydrogen, incomplete combustion factor and soot index specifications with the Gas Safety (Management) Regulations (GS(M)R).

Transco, in the final modification report, stated that there would be no operational or capital costs involved with accepting this lower Wobbe gas. Transco acknowledged that the only cost involved would be with regards to calorific value shrinkage (CV shrinkage). However, it considered that the potential impact was believed to be "minor".

After giving full consideration to the affects of this modification proposal, Ofgem was minded to accept the proposed changes to ConocoPhillips NEA. However, before finalising this view, Ofgem asked Transco to provide a clear estimate of CV shrinkage costs. Transco quantified the potential impact on CV shrinkage to be around £1.5 million per annum (please see the attached note provided by Transco).

Ofgem is of the view that the increase in CV shrinkage costs is not minor and before we proceed with consideration of this modification proposal, we are seeking your views on the proposal, together with the new information supplied by Transco.

Responses to this letter and the attached information provided by Transco are requested by 10 May 2004. Responses should be addressed to:

Kyran Hanks
Director, Wholesale Markets
Office of Gas and Electricity Markets
9 Millbank
London
SW1P 3GE

Or send by email to kyran.hanks@ofgem.gov.uk

If you have any further queries in relation to the issue raised in this letter, please feel free to contact me on the above number or Fiona Lewis on 020 7901 7436

Yours sincerely

Kyran Hanks
Director, Wholesale Markets

Network Code Modification Proposal 0681: Amendment to Network Entry Provisions at ConocoPhillips sub terminal at Theddlethorpe
Supplementary Note

Background

This note has been provided to Ofgem in response to a request to quantify the potential impact identified in sections 4a, 7 & 10 of the Final Modification Report. on CV shrinkage should Network Code Modification Proposal 0681 be implemented. Ofgem have asked NGT to consider the incidence of any cost impact, and whether this analysis alters the views expressed by Transco in the Final Modification Report.

Impact on CV Shrinkage

Assessment of CV Shrinkage is complex and depends on forecast of flows and gas quality at specific entry points and configuration of the network to deliver gas to users. However, to inform the potential scale of additional CV shrinkage NGT has undertaken some indicative analysis based upon a number of key assumptions as listed below:

i) the forecast average CV over the next four years at the relevant entry point will reduce by 0.1 MJ/m3;

ii) the price of shrinkage gas – which NGT has based on the forward price curve in order to estimate a projected weighted average price of shrinkage gas for 2004/05; and

iii) since gas from the Theddlethorpe entry point passes through the Hatton multijunction prior to entering the Distribution Networks, it will join gas flows with differing CV characteristics, and it is assumed that this mitigates 50% of the impact on CV shrinkage.

Based on these indicative assumptions, NGT's analysis indicates that CV Shrinkage could increase by 331 GWh, which equates to a cost of about £1.5m per annum.

Incidence of Costs

Under the terms of the current SO incentive schemes in its Licence, Transco would bear 25% of any additional CV shrinkage cost if outperforming relative to the target; 20% if below target; and none of the cost if outside the caps and collars. The remainder of the costs would be reflected in the SO commodity charge. Assuming no change to the existing structure of incentives and charges, beyond April 2007 NGT would expect forecast shrinkage costs to reflect projected conditions. As such, the full cost impact of implementing Modification Proposal 0681 would be reflected in the incentive target cost and in the level of the SO commodity charge.

NGT's View

As a general principle, NGT supports the concept of considering both costs and benefits to inform decision taking. While quantifying the benefits of implementing Modification Proposal 0681 is not straightforward, it may be assumed that subsequent offshore developments will be economic – they would not proceed otherwise. It may therefore be assumed that the average cost of gas entering the system must be lower than otherwise, with a potential economic benefit for consumers.

In terms of the cost of implementing Modification Proposal 0681, CV shrinkage is a transfer rather than resource cost. That is, the potential change in CV shrinkage costs may lead to a change in the costs faced by different parties, but no real resource costs are involved and there is no net change in costs across the value chain as a whole. Hence it could reasonably be concluded that the benefits can be expected to exceed the costs. NGT's position on Modification Proposal 0681 is not, therefore, affected by the analysis of potential shrinkage costs.

The incidence of costs could, however, be regarded as raising issues regarding the way in which costs are targeted to particular players. In general, Transco's charges arte developed with a view to reflecting costs incurred. However, this does not apply to entry charges which, being based on auctions, are intended to reflect bidders willingness to pay rather than NGT's costs incurred. That said, the CV of gas is taken into account in the NGT model of long run marginal cost (Transcost) and, as such, the reserve prices set for each entry point do, in practice, reflect the CV of the gas which is anticipated at the time the modelling is undertaken. The present reserve prices are set at the Unit Cost Allowances (UCAs) specified in Transco's Licence. Having been set as part of the price control arrangements, these are not expected to be amended prior to 2007.