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Dear Colleague

Network Code Modification Proposal 0687 "Alignment with Transco Licence Changes Relating to the Treatment of the Costs of Locational Actions in Transco's SO Incentive Schemes"

Ofgem has considered the issues raised in Network Code Modification Proposal 0687 "Alignment with Transco Licence Changes Relating to the Treatment of the Costs of Locational Actions in Transco's SO Incentive Schemes".

Having had regard to the principal objective and statutory duties of the Authority, Ofgem has decided to direct Transco to implement modification proposal 0687 because Ofgem considers that the proposal will better facilitate the relevant objectives of Transco's network code under standard condition 9 of Transco's Gas Transporters (GT) licence. Ofgem considers that this decision is also consistent with its wider statutory duties[1].

This letter explains the background to the Modification Proposal and sets out the Authority's reasons for its decision.

Background to the proposal

On 5 February 2004, following an earlier open letter[2], Ofgem published a proposals document[3] in relation to Transco's National Transmission System (NTS) System Operator (SO) scheme from April 2004. As part of its consultation, Ofgem proposed that the costs of locational gas balancing actions should be included within Transco's entry capacity buy-back incentive. This was on the basis of the substitutability between locational gas balancing actions in the On-the-day Commodity Market (OCM) and buying back entry capacity rights as constraint management tools. The majority of respondents to Ofgem's consultation were supportive of this proposal.

[1] Ofgem's principal objective and general duties are contained within section 4AA of the Gas Act 1986. Ofgem's principal objective is to protect the interests of consumers. In carrying out its functions, the Authority has regard to social and the environmental matters.
[2] See 'Transco's National Transmission System Review of System Operator incentives 2002-7: Scope of review – Open letter', Ofgem, August 2003.
[3] See 'Transco's National Transmission System Review of System Operator incentives 2002-7: Proposals document', Ofgem, February 2004.

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On 3 March 2004, in light of broad support for the proposals from market participants, Ofgem issued a notice pursuant to section 23(3) of the Gas Act 1986 outlining proposals to modify sections of Transco's GT licence in order to implement proposed changes to Transco's NTS SO scheme. Following consideration of responses to the statutory consultation, Ofgem subsequently directed a modification to Transco's GT licence[4] to give effect to the proposals outlined in its February 2004 proposals document from 1 April 2004.

As part of the licence modifications to implement Transco's revised SO incentive scheme, the entry capacity buy-back incentive now includes the costs and revenues resulting from locational energy actions and Physical Renomination Incentive (PRI) Charges to reflect that locational energy actions are substitutable for entry capacity buy back actions. Alongside this revision, Ofgem stated that the above costs and revenues should be apportioned in line with Users' entry capacity holdings (i.e. on end-of-day firm entry capacity holding rather than on energy throughput).

Transco's revised GT licence also includes a new term, 'Locational Actions', which is defined as:

> "any action taken by the licensee where the action was taken in respect of a specific location and would therefore be coded with a locational reason code on the OCM. Locational buys will be treated as a cost to the licensee and locational sells will be treated as a revenue."

Transco is of the opinion that changes to its network code are necessary to reflect the changes to its GT licence.

The modification proposal

Modification proposal 0687 was proposed by Transco on 12 March 2004 in order to align its network code with its revised SO incentive scheme under its GT licence. The modification proposal seeks to remove locational actions (as now defined in the GT licence) from Balancing Neutrality and transfer them to Capacity Neutrality, and also to address associated invoicing arrangements. Additionally, the modification proposal seeks to remove PRI Charges from Balancing Neutrality and include them in Capacity Neutrality.

Transco is of the view that the following areas need to be addressed to align its network code with the revisions to its GT licence:

- remove Locational Actions from Balancing Neutrality;
- add Locational Actions to Capacity Neutrality;
- remove PRI Charges from Balancing Neutrality;
- add PRI Charges to Capacity Neutrality; and
- make associated changes to energy and capacity invoicing arrangements.

Respondents' views

There were seven responses to modification proposal 0687. Three respondents were against the proposal, whilst four respondents offered qualified support.

[4] See 'Modification of Transco plc's Gas Transporters licence pursuant to section 23 of the Gas Act 1986', found at: http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/6759_8004.pdf

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A number of respondents felt that it was important to align Transco's network code with the GT licence in order to provide consistency across the arrangements. These respondents recognised that modification proposal 0687 would facilitate this objective.

One respondent offering qualified support suggested that to the extent that the modification proposal does not confer greater incentives on Transco to use locational transactions, the modification needs to be implemented to avoid a conflict between Transco's network code and its GT licence. Another respondent offering qualified support considered that there may be logic in placing actions which relate to specific entry points together for the purposes of the neutrality mechanisms.

A further respondent offering its qualified support for the modification proposal considered that it would be irrational for Ofgem not to approve the modification, having amended Transco's GT licence to transfer the costs of locational actions from Balancing Neutrality to Capacity Neutrality. However, a number of respondents offering qualified support felt that the original licence revision was flawed. Of these, several respondents disagreed with the premise that locational gas balancing actions taken on the OCM to remedy locational network constraints were analogous to buying back entry capacity rights. One such respondent considered that locational transactions would not, in general, be as efficient as capacity buy backs.

Several respondents felt that there has not been sufficient justification to the allusion that conducting a locational sell at a specific system entry point would cause there to be a deficit of gas on the system such that a similar locational buy action would need to be taken for resolution purposes. One such respondent considered that Transco has the option of buying title gas under Balancing Neutrality and would not need to utilise locational buys under Capacity Neutrality.

One respondent that was against the modification proposal felt that it did not resolve the issue that the incentives, as contained in Transco's licence, do not appropriately treat the costs associated with locational sell actions, potentially leading to undesirable consequences. Moreover, this respondent felt that Transco benefits from undertaking a locational sell action to relieve a constraint at an entry point as it would receive revenue rather than face a cost that would result from a capacity buy-back. The respondent felt that, from an incentives perspective, Transco would always favour locational sells over capacity buy-backs.

Another respondent that was against the proposal suggested that the drafting associated with 'Locational Actions' extends the scope of what is considered as locational to OCM Title and OCM Physical transactions, which would not ordinarily be considered to be locational in nature. As a consequence, this respondent felt that it could not support the proposal because it would appear that Transco has the scope and discretion to tag which actions are considered to be locational, possibly to the detriment of the intent of its NTS SO incentive scheme.

The final respondent against the proposal concurred with the views reflected above, by suggesting that it would not appropriately apportion the costs of locational actions. This respondent felt that there remains considerable ambiguity and scope to interpret both the licence and Transco's network code such that inappropriate gas flows planned by Transco could be taken into account, including gas flows planned for balancing purposes.

Transco's view

In March 2004, Transco consented to the modification of its GT licence such that the Entry Capacity Buy Back Incentive now includes the costs and revenues resulting from locational energy actions and PRI Charges on the premise that locational energy actions are substitutable

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for entry capacity buy back actions. In addition, these costs and revenues should now be apportioned according to Users' entry capacity holdings, such that locational energy actions and PRI Charges are calculated on end-of-day firm entry capacity holding rather than on energy throughput.

In order to align Transco's network code with the revisions made to Transco's GT licence as part of its NTS SO incentive scheme, Transco recommends implementation of modification proposal 0687.

Ofgem's view

Ofgem has carefully considered the views of all the respondents and Transco on modification proposal 0687. Ofgem does not consider that the consultation in relation to modification proposal 0687 has raised any new issues which had not already been considered when it revised Transco's GT licence to give effect to its proposals for Transco's SO incentive scheme from April 2004. Having had regard to its principal objective, Ofgem considers that this modification proposal does better facilitate the achievement of relevant objective (b) of Transco's network code. Ofgem also considers that this decision is consistent with its wider statutory duties.

Relevant objective 9(b) of the GT licence – the efficient discharge of its obligations under this licence

As detailed in its proposals document in February 2004, Ofgem considers that locational gas balancing actions taken on the OCM to remedy locational network constraints may have a similar impact to buying back entry capacity, as both measures serve as constraint management tools. Due to this substitutability, Ofgem considered that not including locational gas balancing actions within the Entry Capacity Buy-back scheme could allow Transco to use such actions without being required to bear any of the costs. Ofgem considered that this could serve to bias the decision made by Transco when determining which tool to use to resolve a constraint. However, if both constraint management tools are included in the scheme, Ofgem considered that Transco would then face the same proportion of cost and would therefore be able to make an unbiased decision as to which balancing action to take.

Ofgem's proposals in relation to the way in which locational balancing actions should be treated were inserted into Transco's GT licence to apply from 1 April 2004. In the explanatory notes that accompanied the Section 23(3) notice, Ofgem considered that by incorporating locational balancing actions into Capacity Neutrality would allow Transco to more efficiently incur balancing costs. For this reason, Ofgem considered that the proposed changes to Transco's GT licence would better facilitate the relevant objective 9(b) of Transco's GT licence - the efficient discharge of Transco's obligations under its GT licence. Ofgem continues to consider that this is the case.

Ofgem considers that modification proposal 0687 gives effect in Transco's network code to the changes in Transco's GT licence implemented by Ofgem as part of Transco's 2004-07 SO incentives. To this end, Ofgem considers that modification proposal 0687 serves to align Transco's network code with its GT licence. Furthermore, Ofgem does not consider that the consultation in relation to modification proposal 0687 highlighted any additional issues which had not already been considered when developing Transco's SO incentive scheme to apply from April 2004. Therefore, Ofgem considers that this modification proposal better facilitates achievement of relevant objective (b) of Transco's network code.

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In addition, Ofgem notes that it may be appropriate for Transco to review its Procurement Guidelines and its System Management Principles Statement to reflect the substitutability between locational gas balancing actions in the OCM and buying back entry capacity rights as constraint management tools.

Ofgem's decision

For the reasons outlined above, Ofgem has decided to direct Transco to implement network code modification proposal 0687 because Ofgem considers that it better facilitates the achievement of the relevant objectives as outlined under standard condition 9 of Transco's GT licence and is consistent with the principal objective and statutory duties of the Authority. In particular, Ofgem considers that this modification proposal better facilitates the achievement of the relevant objective set out under standard condition 9 (b) of the GT licence – the efficient discharge of its obligations under this licence.

If you have any queries in relation to the issues raised in this letter, please feel free to contact Simon Bradbury on 020 7901 7249 or David Hunt on 020 7901 7429.

Yours sincerely

Kyran Hanks
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