Shippers, Transco and other interested parties

Our Ref: GTD/TRA/MS/3
Direct Dial: 020 7901 7008
Email: andrew.walker@ofgem.gov.uk

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Dear Colleague,

Network code modification proposal 0696 *Removal of 1/15th Capacity Charge Credit when Interruption is for Supply and Demand Balancing Purposes*

Transco raised network code modification proposal 0696 *Removal of 1/15th capacity charge credit when interruption is for supply and demand balancing purposes* on 14 May 2004.

Ofgem has carefully considered the views of the respondents to this modification proposal and has decided to reject this proposal because it does not better facilitate the relevant objectives of Transco's network code, as set out in standard condition 9 of Transco's Gas Transporters (GT) licence.

In making this decision Ofgem had regard to its statutory duties and Transco's obligations under its GT licence.

The background to the proposal and the reasons for the decision are set out below.

Background to the proposal

Where demands on the gas transportation system exceed available capacity, Transco can use a range of tools, including the interruption of designated interruptible sites, to maintain system security to firm customers.

Transco's NTS System Operator (SO) incentives for 2002-2007 set out two stages of reform for the exit capacity regime including a transitional exit capacity incentive to apply until April 2004 and proposals for the long-term reform of the exit capacity arrangements to apply thereafter.

The licence conditions that introduced the transitional exit arrangements required Transco to make additional payments to shippers with respect to NTS and LDZ supply points interrupted for more than 15 days. The obligation to pay for additional interruption was designed to provide an

incentive for Transco to contract for the level of interruption it required through market based mechanisms. Market based arrangements would allow shippers to be efficiently compensated for the level of interruption that they were providing. The arrangements would also provide signals as to the value of interruption on the network and would allow Transco to make efficient trade offs between the system management services and network investment.

Gas balancing arrangements

Gas balancing arrangements are currently divided into primary balancing obligations, placed upon shippers and residual gas balancing obligations, borne by Transco and set out under the network code. The gas balancing regime provides shippers with incentives to balance demand and supply at the end of the gas day through the cash out mechanism. The current SO arrangements incentivise Transco as residual gas balancer to reduce the costs it incurs as a result of balancing the pipeline system. Transco undertakes this task using a range of physical and financial tools, including its use of interruption and linepack.

The cash out regime

Shippers who are long (short) on gas are cashed out at the lowest (highest) prices at which Transco has sold (bought) gas on the on-the-day commodity market (OCM)[1]. These cash out prices are the system marginal sell price (SMP sell) and the system marginal buy price (SMP buy) respectively. In the event that Transco has not taken any balancing actions, cash out prices are determined using fixed differentials that are added to the system average price (SAP) which is the weighted average price of gas traded on the OCM. The fixed differentials are based on the cost of storage.

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 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 may sell gas to bring the system back into balance.

Exit and interruption arrangements

Transco currently manages network and other constraints under the existing exit capacity, interruption and liquefied natural gas (LNG) arrangements mainly by interrupting gas supply to customers with interruptible transportation agreements. Transco may call interruptions in the event of network capacity constraints, where forecast system demand exceeds 85 per cent of system 1-in-20 peak day demand, in an emergency or for testing purposes.

Interruptible transportation arrangements can be included in contracts between shippers and their customers. Typically, such contracts provide both for some level of shipper interruption (commercial interruption) as well as Transco interruption. At present, any supply point that has daily metering and annual consumption in excess of 5.86 GWh can apply for interruptible status.

In terms of Transco interruptions, Transco distinguishes between Standard Interruptible (SNI) and Transco Nominated Interruptible (TNI) supply points. An SNI agreement allows Transco to interrupt the site for up to 45 days each year, while a customer with a TNI agreement may face

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[1] The on-the-day commodity market is an electronic trading system where shippers and Transco may post and accept offers and bids to effect market transactions. The system buy and sell actions taken by Transco to alleviate a locational constraint on the NTS are not included in cash out prices.

greater than 45 days of interruption. In addition, Transco may unilaterally designate an interruptible point (either a SNI or a TNI) as a Network Sensitive Load (NSL). Such loads, by virtue of their location, are more likely to be interrupted.

In return for having interruptible status, a customer receives relief from capacity charges. SNI and TNI sites pay no National Transmission System (NTS) exit capacity or Local Distribution Zone (LDZ) capacity charges. No additional compensation is provided to an NSL.

Transco's residual balancing incentive

Transco's gas balancing incentive has two components.

- The price component provides Transco with a daily financial incentive to buy and sell gas at prices close to the average market price. Transco earns revenue if it minimises the spread between its marginal buy price and marginal sell price or if it takes no actions. Transco is exposed to a penalty when the differential between the marginal buy or sell price exceeds 20 percent of system average price (SAP).

- The linepack incentive is designed to discourage Transco from carrying over imbalances from day to day as this would lead to less accurate cost targeting under the regime. Companies that were out of balance at the end of the day might not face the costs associated with Transco's actions.

PC 74

In July 2002, Ofgem approved pricing consultation 74, *'Interruptible Transportation Charge's*, (PC 74). PC 74 proposed that, in addition to the existing interruptible exemptions from the relevant NTS exit capacity and LDZ capacity charges, a transportation credit would be paid when individual supply points are interrupted for more than 15 days in a year.

Modification proposal 0555 'Interruptible Transportation Charges'

In October 2002, Ofgem accepted modification proposal 0555 *'Interruptible Transportation Charges'* which introduced a reduction in the level of transportation charges in respect of supply points that Transco interrupts on more than 15 days in a year (measured from April to March). Under the modification, for each day of nominated interruption over 15 days, a transportation charge credit would be available, equivalent to 1/15 of the annual NTS exit capacity charge and LDZ capacity charges avoided as a result of the supply point having interruptible rather than firm transportation rights. Transco's existing right to interrupt a supply point for up to 45 days a year, or more for TNI supply points, was unchanged.

The modification proposal

Transco raised modification proposal 0696 in May 2004. It proposes removing the payment of the 1/15th credit to users of interruptible supply points where Transco calls for interruption to resolve a supply deficit (ie when it considers the market will no longer provide a physical response in an appropriate time period).

Transco would continue to have the right to interrupt for supply and demand purposes as part of the interruption regime, however, the 1/15th credit would not be paid to shippers by Transco for interruptions relating to supply and demand balancing.

Transco suggested that this proposal would sharpen incentives on shippers to contract for commercial interruptions, thereby promoting the effective balancing of shippers' portfolios during periods of tightening supply and demand.

Respondents' views

There were nine responses to modification proposal 0696. These are available on Transco's Information Services (Nemisys) website. Set out below is a summary of the main issues raised by respondents.

Two respondents expressed support for the proposal. A further two respondents offered qualified support. The remaining five respondents were against the proposal. Five of the respondents agreed with the principle of removing the 1/15th credit for supply and demand balancing from the exit capacity investment incentive arrangements, however four of these respondents said this proposal was not the appropriate vehicle to implement this.

The common objection across the five respondents who were against the proposal was that removing the credit could perversely create an incentive for Transco to call interruption for supply and demand purposes (since this would be a free option), rather than for transportation constraints and rather than effectively utilising the OCM. A number of respondents commented that this proposal was not sufficiently comprehensive to facilitate the appropriate treatment of costs due to balancing actions.

The two respondents who offered qualified support, did so on the basis of further developments being necessary to prevent the possible negative impact that could arise from the proposal. One respondent was concerned that Transco might not utilise the OCM fully to alleviate any constraints before resorting to interruption. The second respondent agreed with the removal of this credit from the incentive mechanism but only if a second proposal was implemented concurrently introducing a payment from Transco for supply and demand interruption.

Transco's views

Transco stated that it has attempted to reassure parties that Transco would utilise the OCM to its full extent in preference to supply and demand interruption (until such point that it felt that there were no more actions that would provide an appropriate physical response in an acceptable time period). Transco stated that it would make an amendment to the System Management Principles Statement (SMPS) to provide further assurance with respect to these matters.

Ofgem's views

Ofgem agrees with the principle of promoting more efficient arrangements for gas balancing through shipper led commercial interruption contracts. Gas balancing and transportation interruption should be separated to reflect the costs that Transco incurs in separately managing its residual gas balancing and transportation capacity management roles. The existing Transco interruption arrangements may potentially distort the efficiency of the gas balancing regime. This is because the costs of interruption for gas balancing purposes under existing Transco contracts are not reflected in gas cash out prices. Nevertheless, it is not clear that the change proposed as part of modification 0696 would deal with these difficulties.

While Ofgem notes Transco's assurance that it would utilise the OCM to its full extent to manage its residual gas balancing role, under modification proposal 0696 Transco would have a free option to interrupt customers under the existing administered interruption contracts as opposed to using market based arrangements to balance the system.

Ofgem considers that Transco's proposals could be better addressed as part of the overall framework of Ofgem's current review of the cash out arrangements and through the review of the existing exit arrangements initiated through the Distribution Network (DN) sales project.

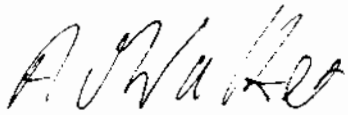
Ofgem's decision

For the reasons outlined above, Ofgem has decided to reject network code modification proposal 0696 as it does not better facilitate the relevant objectives of Transco's network code under standard condition 9 of Transco's GT licence. In particular, modification proposal 0696 does not better facilitate the efficient and economic operation of Transco's pipe-line system.

As a result of rejecting this modification proposal, the current arrangements for Transco crediting shippers for interruption over 15 days will remain in place.

If you have any further questions on this letter please do not hesitate to contact Matthew Young (tel 020 7901 7266).

Yours sincerely



Andrew Walker
Director – Transmission Networks Regulation