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Shippers, Transco and other
interested parties

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Dear Colleague,

Network code modification proposal 0652 *'Revision of supply point ratchet charge multiplier for gas year 2003/4'*

Ofgem has carefully considered the issues raised in network code modification proposal 0652 *'Revision of supply point ratchet charge multiplier for gas year 2003/4'*. Ofgem has decided to direct Transco to implement modification proposal 0652 because we believe that this proposal will better facilitate the achievement of the relevant objectives of Transco's network code under standard condition 9 of Transco's Gas Transporters (GT) licence.

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

Background to the proposals

Exit capacity regime

Under the current exit arrangements Transco allocates capacity on an administrative basis among Daily Metered (DM) Supply Points, Non Daily Metered (NDM) Supply Points and non-NTS Connected System Exit Points (CSEPs).

In particular, each user is registered as holding supply point capacity (also referred to as supply point offtake quantity or SQ), which is subject to a maximum and a minimum requirement. Under

Transco's network code, shippers are required to nominate or amend SOQ data for a supply point taking account of historical information and future load requirements.

Ratchet charges

Ratchet charges are intended to provide incentives for shippers to book sufficient SOQ for each of their firm DM supply points and to ensure that Transco has made sufficient capacity available to firm DM sites to meet demand in peak flow conditions.

In the event that the amount offtaken by a DM supply point i.e. the supply point daily quantity (SPDQ), exceeds the SOQ during the winter period, defined as 1 October to 31 May, shippers incur a supply point ratchet charge for the quantity of gas that exceeds the SOQ. In most of these instances the SOQ would be increased to the level of the SPDQ from the day after the breach. However, if the SPDQ is in excess of the provisional maximum SOQ (PMSOQ) the new SOQ is capped at the PMSOQ. The PMSOQ cannot exceed two times the SOQ.

The ratchet charge is two times the sum of the applicable annual LDZ capacity charge and the capacity variable component of the customer charge. The network code also sets out ratchet charges in the event of repeated breaches where the SPDQ exceeds the capped SOQ over the winter period. Whilst the functionality for charging for repeated breaches has not been implemented yet, in 2002 Transco notified shippers of its intention to implement these charges from 1 October 2003 in order to comply with its network code obligations.

In circumstances where there is no scope for the supply point to reduce its actual usage, as reflected in the SPDQ, below the SOQ, shippers must seek approval from Transco to increase the SOQ in order to avoid ratchet charges. In determining whether such approval can be granted Transco will take account of the existing pipeline capacity availability and whether further system reinforcement would be required.

Modification proposal 0645 'Treatment of sites where continuous SOQ breach (supply point ratchet) has occurred'

In August 2003, BP Gas marketing Ltd (BP) raised modification proposal 0645 which proposed to keep the initial 'day 1' ratchet charge at two times the relevant capacity charges but to reduce 'day 2' charges in the event that a shipper has demonstrated that it has sought to address the breach (e.g. with a request to Transco for a capacity increase).

At the NT&T workstream on 17 September 2003, Transco indicated that it did not have the system functionality needed to implement two step charging for ratchets by 1 October 2003. Therefore, BP

withdrew the proposal on 23 September 2003 and Transco raised urgent modification proposal 0652 as a temporary solution to the issues raised by BP.

The proposal

It is proposed that in the event that the SPDQ of a firm DM supply point exceeds the SOQ in the first instance and repeatedly breaches the capped SOQ, the ratchet charge for the excess quantity of gas offtaken should be reduced to 0.01 times the sum of the relevant annual capacity charge and the capacity variable component of the customer charge. This effectively limits each ratchet charge to the equivalent of 3.7 days of capacity charges. The duration of the modification proposal is for the period from 1 October 2003 to 31 May 2004 only. From 1 October 2004, the multiplier will revert from 0.01 to 2.

Respondents' views

There were nine responses to the consultation. Most respondents supported the modification proposal with a small number providing qualified support only.

Most of the respondents commented that the existing level of ratchet charges is very high and could be perceived as creating a punitive regime.

Some respondents noted that there can be difficulties in revising the SOQ and obtaining extra capacity from Transco when a customer's SOQ is lower than its required capacity. According to these respondents, these difficulties could have led to systematic SOQ breaches.

Several respondents stated that the proposal weakened the incentives on users to book an appropriate level of capacity which is consistent with the expected requirements by end-users. A number of these respondents believed that it would be appropriate for sites that persistently breach their SOQ to face reduced financial consequences only in the event they were genuinely unable to manage their exposure to capacity ratchets. Some respondents commented that the proposal provided an approach that ensured that the ratchet charge was less punitive but at the same time retained the necessary incentives to book supply point capacity.

Most respondents agreed that this modification proposal should be implemented on a temporary basis and suggested that a further review of ratchet charges would be appropriate to devise a long-term remedy to the issues raised by modification proposal 0645. A respondent also suggested looking at whether the PMSOQ is an adequate or an

arbitrary limit to capacity available on the system. One respondent specifically stated that the PMSOQ is set by an arbitrary process.

Some respondents proposed that Transco could monitor ratchet charges for persistent capacity breaches to identify whether shippers are taking advantage of the diluted incentive to book less capacity than required.

Transco's view

Transco raised this modification proposal as a pragmatic way to ensure that the risk of potentially significant ratchet charges is removed before they are implemented on 1 October 2003. However, Transco's support was conditional on the transitional nature of the proposal.

It believed that implementation of this modification proposal should trigger a review of the incentive regime that under-pins the booking of SOQ at firm DM sites.

Transco considered that the proposal would avoid the possibility of severe financial hardship for a number of shippers and consumers¹, while retaining some incentive on users to remedy their SOQ breaches during the forthcoming winter. Transco stated that the proposal would serve to facilitate a less risky and more competitive environment in which shippers could operate.

Transco also considered that its contractual right to charge ratchet charges could be the subject of a legal challenge should such charges be perceived as punitive.

Ofgem's view

Ofgem considers that, in principle, ratchet charges are an appropriate means of providing an incentive on shippers to book the correct level of supply point capacity, thus allowing Transco to plan and manage its transmission system. However, whilst Ofgem agrees that there needs to be an appropriate incentive on shippers not to exceed their capacity limits, we are nevertheless concerned that the existing level of ratchet charges may not reflect the costs imposed on the system by those shippers who are in breach of these SOQ limits. In this respect, Ofgem is concerned that the ratchet charges that shippers could incur from 1 October 2003 may not facilitate competition between shippers and suppliers.

Ofgem would also note the concerns raised by some shippers that it is difficult to obtain the capacity they need from Transco in a timely manner and that such shippers may therefore incur ratchet charges regardless of their willingness to remedy their breach. In

¹ Transco stated that for a number of supply points the ratchet charges would exceed £1million.

these circumstances the application of the present level of ratchet charges from 1 October 2003 appears inappropriate.

Accordingly therefore, Ofgem considers that this modification proposal would provide a transitional relief from the risk of severe charges on some shippers, whilst a longer-term solution is developed by the industry. This should help to secure effective competition between relevant shippers and suppliers.

Ofgem recognises the concerns expressed about customers deliberately booking a low SOQ to avoid capacity charges. For this reason, Ofgem agrees with respondents that a review of the incentive arrangements underpinning the booking of SOQ at DM sites is required and a longer-term solution needs to be developed by the time this modification expires on 31 May 2004.

Further, Transco should monitor shippers' behaviour to ensure that repeated breaches of SOQ values are inputted into the review process and also reported to Ofgem. In this respect, Ofgem would remind shippers of their licence obligation not to provide misleading information to Transco about intended gas flows as part of the SOQ setting process and also their licence obligation not to prejudice the safe and efficient operation of the transportation system.

In addressing any long term solutions, Ofgem agrees with respondents that Transco should review the mechanisms for setting maximum supply point capacities in order to ensure that these capacity levels do not result in any capacity being artificially withheld from the market. Ofgem raised these concerns in its decision letter on modification proposal 0556² and notes that they have not, as yet, been addressed by Transco. Ofgem believes that the present discussions being undertaken by industry participants on reforms to Transco's exit capacity regime would provide an appropriate opportunity for such a review.

Ofgem's decision

For the reasons outlined above, Ofgem has decided to approve modification proposal 0652 for implementation for the period 1 October 2003 to 31 May 2004 as we believe that this modification will better facilitate the achievement of the relevant objectives as outlined under standard condition 9 of Transco's GT licence. In particular, Ofgem believes that modification proposal 0652 will better facilitate the securing of effective competition between relevant shippers and suppliers.

²Modification proposal 0556, '*Amendment to minimum capacity requirements for interruptible DM sites*', Ofgem decision letter, 18 October 2002.

If you have any queries in relation to the issues raised in this letter, please feel free to contact me on the number above or Samanta Padalino on extension 7033.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Mark Feather', written in a cursive style.

Mark Feather
Head of Gas Trading Arrangements