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Our Ref: Net/Cod/Mod/0657
Direct Dial: 020 7901 7021
Email: Kyran.hanks@ofgem.gov.uk

Shippers, Transco and Other Interested Parties

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Dear Colleague,

Network Code Modification Proposal 0657 “Partial Volume Interruption Service”

Ofgem has carefully considered the issues raised in network code modification proposal 0657 “*Partial Volume Interruption Service*”. Ofgem has decided not to direct Transco to implement modification proposal 0657 because it does not believe that the proposal will better facilitate the relevant objectives of Transco’s network code under standard condition 9 of Transco’s Gas Transporter (GT) licence.

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

Background to the proposal

Exit capacity regime

Transco currently manages network 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 interruption in the event of network capacity constraints, high system demand¹, in an emergency or for testing purposes.

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 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

¹ Transco can call an interruption for supply/ demand balancing purposes when forecast national demand is greater than 85% of the forecast peak day demand.

virtue of their location, are more likely to be interrupted. Interruptible customers receive relief from NTS exit capacity charges.

Existing partial interruption service

The current arrangements provide shippers with the ability to nominate their interruptible supply points for partial interruption rather than a complete cessation of flows. In order to use this service, shippers effectively elect to subdivide their maximum daily offtake quantities into tranches. As part of the interruption process, Transco will identify which tranches are interrupted. The uninterrupted tranches define the maximum hourly offtake following the commencement of the period of interruption.

The partial interruptible service is only made available at sites where metering equipment is available to assess performance against the service. The current arrangements allow Transco to charge shippers in the event that they fail to interrupt or meet the nominated hourly flow rate reduction.

Winter Operations Report

Transco released its 2003/4 Winter Operations report in October. The report raised two key concerns with respect to the gas trading arrangements, namely that:

- ◆ There is a risk that gas sector winter security could be less than that necessary to meet 1 in 50 year winter demands. Transco's analysis is based upon an assessment of reduced beach availability (95% as opposed to 100% availability) and the historical use of storage to support interruptible demand (based on experience over recent winters). As a result of this analysis, Transco have indicated that the level of gas security provided by national top-up should be increased.
- ◆ Under prolonged cold conditions it might be expected that some or all CCGT generation plant will be interrupted under Transco interruptible contracts thereby reducing available generation in the electricity market. Transco stated that under these conditions generation margins could be reduced to between a deficit of 0.1 GW and a surplus of 0.7 GW following interruption of CCGTs.

Transco considered these two risks to be 'worst case' scenarios with a low probability of occurrence.

The proposal

The proposal seeks to extend the present partial interruption arrangements so that supply points are permitted to offtake at rates higher than those available under the present partial interruption service. In particular, it is proposed that Transco would be granted the discretion to offer partial volume interruption (as opposed to partial rate interruption) services to shippers, whereby a partial interruption supply point is made subject to a daily offtake quantity limit rather than an hourly limit on flows. This would allow supply points to vary their gas offtakes throughout the period in which they have been partially interrupted subject to a supply point maximum hourly rate as specified in the relevant interruption notice. Transco has indicated that the volume service will only be made available when system flexibility allows.

In raising the proposal Transco has indicated that it would assist those CCGTs with interruptible contracts in meeting peak electricity demand.

Respondents' views

There were ten respondents to the proposal. A small majority of respondents supported the proposal.

A number of respondents noted that the proposal could ensure that peak electricity demand is met by allowing the profiling of gas supplies to CCGTs. Respondents noted that it could provide additional flexibility to shippers with respect to interruption on peak days and may alleviate concerns about the electricity security of supply this winter.

Some respondents raised concerns that Transco could discriminate against certain interruptible sites and that Transco may require more frequent interruption at certain sites so as to provide system flexibility to CCGTs. Other respondents stated that Transco should be able to demonstrate that the allocation of the service does not favour or discriminate against any individual or group of customers.

Several respondents were also concerned about the role of Transco's discretion in offering additional flexibility. In particular, concerns were raised that the criteria that Transco would apply in offering the proposed service were unclear. One respondent stated that decisions on whether to allocate and call upon the service should be based on a transparent and fair methodology that is made public. Another stated that transparent procedures should be developed so that all customers can know how to access the flexibility made available through the proposal.

Some respondents noted that Transco is using the interruptible services for addressing supply/demand imbalances when it is the On-the-day-Commodity-Market that should be used for balancing purposes. Respondents commented that using interruption for supply and demand purposes could distort the market with one respondent commenting that it could reduce incentive on shippers by limiting the extent to which the price of gas traded on the OCM rises.

Transco's view

Transco supported the implementation of modification proposal 0657.

Transco noted that the winter operations report for 2003/4 highlighted the possibility of significant volumes of interruption to address supply/ demand imbalances in the event of a severe winter. Transco believed that the enhancements to the partial interruption service could, to some extent, mitigate against the possible impact on interruption this winter by making additional flexibility available.

Transco also suggested that the service could enhance the ability for CCGTs to satisfy peak electricity demand and might benefit security of electricity supply. Transco also argues that the proposed service will allow greater access to system flexibility when such flexibility is available thereby providing end users with greater flexibility to manage interruption obligations in the context of managing supply point and alternative energy requirements. Transco stated that this was consistent with the safe, efficient and economic operation of the gas pipeline system.

In response to concerns about possible discrimination between interruptible sites, Transco noted that it has an obligation not to be unduly discriminatory and that the proposed partial interruption service would be available to all supply points that qualify subject to there being no locational constraints. Further, Transco stated that partial interruptible status will be made available to all those that meet the relevant network code requirements.

Transco agreed that actions on the OCM would be used as the primary residual supply and demand balancing tool. However, Transco noted that it is entitled to use interruptions to alleviate such imbalances and, as such, these could be used as a back up measure.

Transco noted respondent's views that information on within day flexibility and the criteria for using the proposed partial interruption service should be transparent and disclosed to the market. Transco argued that system flexibility would be assessed on the day and as such advance notification was not possible.

Transco indicated that it could not comment upon the effect that the proposal may have on NGC's incentives as any impact would be indirect.

Ofgem's view

Ofgem has carefully considered the views of Transco and respondents on this proposal. Having considered these views, Ofgem has identified number of concerns with the proposal and is not satisfied that it would better facilitate the relevant objectives of Transco's network code.

In principle, Ofgem would support a proposal that sold within day flexibility to customers. We consider that such a service would assist shippers in managing their gas and, potentially, electricity requirements within the gas day. Of course, we note that within day flexibility is already offered by Transco in the form, for example, of network exit agreements and more generally.

However, there are several points that lead us to reject this proposal at this time. First, we are concerned that the implementation of this proposal would create the potential for discrimination between different classes of customers. That is, offering within day flexibility without charge means that there is no way that costs can be efficiently targeted. In this respect, Ofgem is concerned that the allocation of within-day flexibility for free to some shippers may lead to costs that are imposed upon other shippers and, potentially, customers (eg to the extent that Transco is required to interrupt other customers or to take system balancing actions, the costs of which are spread across shippers).

In this respect, Ofgem has sought assurances from Transco that the provision of partial volume interruption services would not impose costs upon customers. Transco has not been able to provide such assurances.

Second, Transco has not proposed publishing any criteria or systems information for establishing how it would allocate the proposed services to shippers. In particular, the lack of transparency will make it difficult to assess whether Transco is unduly discriminating between interruptible customers and could also make it difficult for Ofgem to determine whether Transco is acting in an unduly discriminatory manner. It would have been possible to require an ex post audit of the

proposal. However, given the decision to reject, we have not progressed this point with Transco.

Third, Ofgem has been reluctant to allow changes to Transco's network code without sufficient notice. This applies in particular during the Winter period. This does not preclude changes during the Winter, but a strong case must be made. This has not been done with respect to this particular proposal.

In summary therefore, Ofgem is not satisfied that the proposal would better facilitate the securing of effective competition between shippers and suppliers. Indeed, Ofgem is concerned at the potential impacts that the proposal may have on competition within the gas sector.

Further, Ofgem considers that the free use of within day flexibility could act against the efficient operation of Transco's system by potentially increasing the potential for system balancing actions. As such, Ofgem is not satisfied that the proposal would better facilitate the efficient and economic operation of Transco's pipeline system.

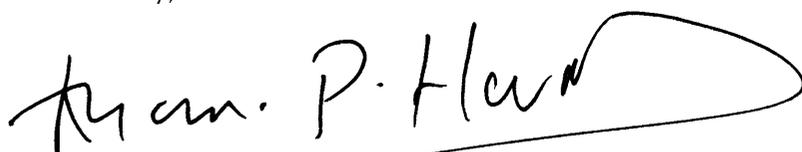
To the extent that Transco wishes this proposal to be in place for next Winter, we suggest that it is put to workstream for development, in time for full consideration to be given to the proposal in time for next Winter.

Ofgem's decision

For the reasons outlined above, Ofgem has decided not to direct Transco to implement network code modification proposal 657 as we do not believe that the proposal better facilitates the achievement of the relevant objectives as outlined under standard condition 9 of Transco's GT licence. In particular, Ofgem believes that the proposed partial interruption service could lead to discrimination and could therefore distort competition between shippers and suppliers. Ofgem also does not consider that the modification proposal will better facilitate the efficient and economic operation of Transco's pipeline system.

If you have any queries in relation to the issues raised in this letter, please feel free to contact me on the above number or Mark Feather on 020-7901-7437.

Yours sincerely,



Kyran Hanks
Director, Gas Trading Arrangements