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Shippers, Transco and other interested parties

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Dear Colleague

Network code modification 0639 "Isle of Grain: Change of Status from Liquefied Natural Gas (LNG) Storage Facility to Importation Terminal"

Ofgem¹ has carefully considered the issues raised in modification proposal 0639 to Transco's network code, "Isle of Grain: Change of Status from LNG Storage Facility to Importation Terminal".

Ofgem has decided not to direct Transco to implement modification proposal 0639 because Ofgem considers that the proposal will not better facilitate the relevant objectives of Transco's network code under standard condition 9 of Transco's Gas Transporters (GT) licence.

In this letter, Ofgem explains the background to the modification proposal and gives reasons for making its decision.

Background to the proposal

LNG storage services are currently used by both shippers and Transco. Transco usage of LNG facilities can be for the following purposes:

- **Operating Margins (OM).** Transco purchases and fills some storage capacity to provide stocks of gas that Transco can use at short notice for system balancing purposes over operational timescales such as providing resilience against e.g. plant failures, both onshore and offshore. Transco refers to these bookings as operating margins.
- **Scottish Independent Undertakings (SIUs).** Transco use LNG storage at the Glenmavis LNG storage facility to help meet its obligations in relation to the SIUs. Transco's SIU

¹ Ofgem is the Office of the Gas and Electricity Markets Authority. The terms 'Ofgem' and the 'Authority' are used interchangeably in this letter.



bookings are intended to enable it to supply gas via tanker to four remote towns in western Scotland (effectively extending the NTS to these towns).

- **Constrained LNG (CLNG).** Under the arrangements of Transco's network code, Transco can secure transmission support from LNG facilities by "constraining" them. In these instances, LNG is used by Transco as a substitute for additional pipelines investment. During periods of high demand, the facilities can enable Transco to ensure that sufficient quantities of gas can be delivered in specific localities to meet firm demand avoiding the need for additional investment to pipe the gas to these locations.
- **Constrained LNG Top up requirements.** If market participants book what it considers to be insufficient amounts of CLNG in a given year, Transco can face a requirement to book and fill the shortfall – this is referred to as Constrained LNG (CLNG) Top up.

Isle of Grain

NGT presently owns the LNG storage facility at the Isle of Grain through Grain LNG Ltd (GLNG), a subsidiary separate from Transco. However, this facility is presently operated as a storage facility by Transco under a lease back arrangement from GLNG. As such, it provides storage services to gas shippers using the NTS as well as providing services to Transco.

GLNG is in the process of converting the facility to become an LNG importation and re-gasification terminal. GLNG intends to build, own and operate the terminal, although the scheduling of gas deliveries to and from the facility will be under the control of holders of capacity rights at the facility.

Storage services will no longer be offered by GLNG. In order to meet Transco's requirement for OM at the Isle of Grain and to enable Transco to gain consent from the HSE to convert the facility from its existing use as a storage facility, the importing shipper(s)² for the initial capacity have entered into a Transco Services Agreement to provide system reserve and transmission support services to Transco.

In May 2003, Ofgem published a consultation document³ seeking views on Transco's request to transfer its Isle of Grain facility to a non-regulated NGT group company, with the facility eventually being converted into an LNG import terminal. Ofgem stated that its initial view was that the transfer should be permitted, partly because the development of an import terminal would add to the security and diversity of supply but also because it would provide a competing alternative to storage and interconnector flows.

² BP and Sonatrach were sold rights to 100 per cent of the initial importation capacity including all the existing tank space.

³ 'National Grid Transco's proposal to transfer its Liquefied Natural Gas facility at Isle of Grain to a separate NGT group company, A consultation document', Ofgem, May 2003.

In July 2003, Ofgem published a decision document⁴ which presented Ofgem's decision that it would be appropriate to permit the transfer of the Isle of Grain facility. Ofgem was of the opinion that it would be appropriate to grant permission for the disposal as requested by Transco and detailed in our consultation document.

Transco's system balancing System Operator (SO) incentives schemes

Transco's system balancing incentive consists of two components relating to system balancing costs:

- ◆ NTS SO gas costs (shrinkage); and
- ◆ system reserve (operating margins).

The SO system reserve function is relevant in the context of this modification proposal.

Transco's system reserve target under the current SO incentive arrangements makes an allowance for the costs of booking storage capacity for OM's purposes. The sharing factors associated with this component of Transco's SO incentive arrangements are 100%. Therefore, Transco is exposed to 100% of the costs/savings associated with this capacity element of its system reserve incentive.

The costs of purchasing and selling gas associated with the provision and use of OM's and the costs of injecting gas into and withdrawing gas for OM's purposes are not funded under the current SO incentives. These costs are dealt with through network code arrangements (the so-called "neutrality" arrangements). Transco recovers these costs from shippers via Balancing Neutrality Charges.

Interaction between Transco's contract with Isle of Grain and the existing funding arrangements

Under its contract with the Isle of Grain importation facility, Transco would no longer face capacity charges for holding OM gas in store at Isle of Grain. These capacity charges fall away with Transco instead paying a service fee for the option to withdraw gas for OM's purposes.

The modification proposal

Modification proposal 0639 was proposed by Transco on 11 July 2003. The modification proposal seeks to:

- remove Isle of Grain from the list of Transco LNG Storage Facilities and from the list of Constrained Storage Facilities;
- widen the sources from which Transco can procure OM's and CLNG services to enable provision from 'appropriately located' LNG importation terminals, thereby allowing Isle of Grain (and any other similar importation facility) to provide these services;

⁴ 'National Grid Transco's proposal to transfer its Liquefied Natural Gas facility at Isle of Grain to a separate NGT group company, A decision document', Ofgem, July 2003.

- allow Isle of Grain availability to contribute to the 'maximum daily supply' in the same manner as any other system entry point that is not a storage facility (i.e. Isle of Grain will contribute to Top-up monitors); and
- include the costs associated with Transco's usage of its OM service at Isle of Grain (but not the option fee that provides for the availability of the service) within 'eligible margins costs' which results in the costs being included in the Balancing Neutrality Charges. Currently, eligible margins costs incorporate the amount of gas withdrawn from each storage facility for OM purposes multiplied by the weighted average cost of gas-in-store (WACOG) and balancing charges payable by Transco for OM purposes.

Respondents' views

There were six responses to this proposal. Of the responses, four did not support the modification proposal and two did support the modification proposal.

In general, the respondents that did not support the modification proposal were concerned with Transco's proposal to retain access to storage space for OMs and Top Up at the Isle of Grain import terminal. One respondent suggested that the modification proposal could result in distortions and inefficiencies in the operation of the import terminal. Three respondents were concerned that the proposed storage services at Isle of Grain would only be available to Transco and not other Users.

Two respondents considered that the modification proposal would result in all the costs for OMs at the Isle of Grain being classed as "gas" costs with no costs being classed as "capacity" costs which would benefit Transco directly under its incentive scheme but disadvantage shippers. Two respondents suggested that the proposed method of pricing OM gas is likely to increase the actual costs of OM gas because gas would be purchased when it is required rather than during the summer when the costs of gas are lower which is the current practice.

One respondent considered that if the Isle of Grain is to be treated in the same way as any other non-storage System Entry Point for the purposes of determining maximum daily supply and Top Up Storage Capacity, Transco should not treat it as a Short Duration Storage facility for the purposes of Winter Top Up Requirements. This respondent was under the impression that LNG import terminals would have storage space roughly equivalent to the size of an LNG cargo discharged at the facility and any winter injection nominations could result in LNG shipping inefficiencies.

Two respondents were concerned with the drafting of the legal text which specifically refers to Isle of Grain rather than import terminals generically. One of the respondents that did support the modification proposal did so on the assumption that proposed LNG import terminals other than Isle of Grain would not have an obligation to offer flexibility services as reflected in the drafting of the legal text.

The other respondent who supported the modification proposal considered it appropriate that import terminals be able to provide Constrained Storage services.

Transco's views

Transco supports the modification proposal. Transco considers that implementation of this proposal would facilitate the introduction of new supplies of gas into the system via Isle of Grain whilst retaining access to OM, Top-up and transmission support services following its conversion into an LNG importation facility. Transco considers that this could increase the range of supplies available to shippers, thereby securing effective competition between relevant shippers and relevant suppliers.

In relation to the funding issues linked to Transco's use of OM under its contract with Isle of Grain, Transco argues that the gas price associated with the delivery of the service would be a cost-reflective price similar to the price currently paid by Transco when it uses OM gas and tenders for its replenishment. Transco also argues that, following its conversion to an import facility, Isle of Grain would be expected to flow baseload, thereby reducing the extent to which OM services could be provided and would be required. Transco considers that this should reduce shippers' exposure to market-related prices for OM gas.

Ofgem's view

Ofgem notes that the contract between Transco and Isle of Grain has a gas cost element and an option fee element, with the latter effectively replacing the capacity charges for storage at Isle of Grain. This contract form may affect the overall cost associated with OM provision from Isle of Grain. However, Transco has not demonstrated whether this contract was procured at competitive terms and therefore whether the contract terms are consistent with its licence and statutory obligations. Transco has a statutory obligation to develop an economic and efficient system, and also has a licence obligation to ensure that its transportation business shall not give or receive any cross subsidy to or from any other business of Transco or of an affiliate or related undertaking of it (Standard Condition 41 (Prohibition of Cross-Subsidies)). Ofgem has not approved the contract in question and at present it is unclear to Ofgem whether or not the contract is consistent with Transco's obligations. Ofgem is writing to Transco on this issue.

Ofgem has carefully considered the views of all the respondents and Transco on this modification proposal. Ofgem considers that this modification proposal does not better facilitate achievement of the relevant objectives of Transco's network code.

Relevant objective 9(a) of the GT licence – the efficient and economic operation by the licensee of its pipe-line system

Ofgem considers that it is appropriate for the Isle of Grain to be removed from the list of Transco LNG Storage Facilities and from the list of Constrained Storage Facilities to reflect its impending change in status from a storage facility to a LNG importation terminal. Ofgem further considers that it is appropriate for the sources from which Transco can procure OM and CLNG services to be widened to enable provision from other sources including 'appropriately located' LNG importation terminals. Ofgem has urged Transco, for a number of years, to develop the arrangements to widen the number of companies and facilities that can bid to provide OM and other system balancing services. Ofgem considers that widening the range of sources from which these services can be accessed should lead to greater competition, facilitate innovation in

the provision of OM and other system services and bring pressure to bear on the price at which these services are offered and procured. This would better facilitate efficient and economic operation of the system by Transco.

In respect of the price of OM gas under the proposed arrangements, Ofgem notes that several respondents considered that the actual cost of OM gas will increase compared with the costs of procuring OM gas from the Isle of Grain under the existing arrangements. Ofgem notes that Transco argues that the shipper exposure to these costs could fall. This issue stems back to the nature of the contract that Transco has agreed with Isle of Grain for the provision of OMs, in particular the way in which the gas price element is determined. Ofgem does not consider that Transco has provided sufficient evidence or analysis to demonstrate what the potential change (upward or downward) in the price of OM gas that results from the contract, and hence the likely impact on shipper's exposure to OM costs is likely to be. In the absence of this analysis it is not possible to conclude whether the proposal would lead to more efficient operation of the pipeline system.

The issues surrounding the price of OM gas and the form of the Isle of Grain contract are both relevant to the appropriateness of the methodology by which the costs associated with Transco's use of OMs at Isle of Grain are recovered. As noted above, the existing arrangements provide for a fixed allowance for capacity costs, with full exposure for Transco with respect to costs/savings made when compared with this allowance. By contrast, gas costs (and the costs of injecting and withdrawing gas) can be recovered in full via Balancing Neutrality.

Ofgem has concerns in relation to the appropriateness of the current funding arrangements for OM costs which provide for a separate mechanism for funding depending upon whether those costs are related to storage capacity bookings or whether they relate to the costs of purchasing and injecting/withdrawing gas. Ofgem is of the opinion that it may be appropriate to move to funding arrangements which treat all costs associated with the use of OMs (i.e. gas costs and capacity costs/option fee) consistently.

Ofgem recognises that the existing differential treatment of these costs would continue to exist irrespective of whether or not this modification proposal was approved because the separation between the option fee and the gas costs will remain. However, Ofgem considers that this differential treatment of OM costs may become increasingly inappropriate given potential changes to the price of OM gas and the capacity charge/option fee element if the modification proposal was approved. Ofgem therefore considers that, on the basis of the information currently available, Transco should review whether the existing Balancing Neutrality arrangements remain appropriate given the likely development of new ways of procuring OM gas, including from the Isle of Grain.

Overall, on the basis of the information available, Ofgem considers that it not been demonstrated that modification proposal 0639 would better facilitate the achievement of the efficient and economic operation by the licensee of its pipe-line system.

Other features of the modification proposal

In addition, Ofgem notes that several respondents raised concerns that the modification proposal and associated legal drafting referred specifically to the Isle of Grain importation facility, rather than LNG importation facilities more generally. Ofgem notes that Transco's intention was for OMs and transmission support services to be provided by any LNG importation facility and considers that it may be appropriate for a more generic approach to be taken in relation to any future modification proposals on this issue.

Ofgem also notes that several respondents questioned their ability to access equivalent services at Isle of Grain to those being procured by Transco. Ofgem notes that there is no reason why shippers cannot seek similar arrangements with initial capacity holders at the Isle of Grain. Ofgem is of the opinion that, in principle, market participants should be able to procure equivalent services to Transco at all LNG importation facilities.

Ofgem would like to reiterate that it supports that part of the proposal that would see the Isle of Grain continue to provide OM gas and other system services. Ofgem notes that part of the HSE's approval for the conversion of the facility was the continued provision of these services. As the import terminal is not due to become operational until the first quarter of next year, Ofgem is satisfied that there is sufficient time for Transco to address the concerns that have been raised both by shippers and Ofgem so that the Isle of Grain can be in a position to provide OM services when it becomes operational.

Ofgem's decision

For the reasons outlined above, Ofgem has decided to not direct Transco to implement network code modification proposal 0639 because it considers that it not been demonstrated that modification proposal 0639 would better facilitate achievement of the relevant code objectives as outlined under standard condition 9 of Transco's GT licence.

If you have any further queries in relation to the issues raised in this letter, please feel free to contact Simon Bradbury on 020 7901 7249 or Adam Higginson on 020 7901 7432.

Yours sincerely



Steve Smith
Managing Director, Markets

Signed on behalf of the Authority and authorised for that purpose by the Authority