TRANSCO NETWORK CODE MODIFICATION PROPOSAL No. 0599

"Obligation on shrinkage provider to purchase gas at the NBP"
Version 1.0

Date: 11/11/2002

Proposed Implementation Date: 01/01/2003

Urgency: Non-Urgent

Justification

Under current Network Code rules, the Shrinkage Provider is not required to apply or hold System Capacity or to pay capacity or commodity charges. NTS shrinkage, or own use of gas comprises four elements: unaccounted for energy, unbilled energy, system own use and fuel for electric compressors.

Transco has an incentive under its SO incentive schemes to manage NTS shrinkage costs efficiently. A separate incentive relating to LDZ shrinkage forms part of Transco's LDZ price controls. Customers pay the costs of shrinkage ultimately. Under Transco's NTS SO incentive, Transco is set a volume target for the year and a target price to acquire shrinkage gas. The volume target for this formula year is 8,265GWh. The price target is 0.702p/kWh. Ofgem set this price target by applying a swing premium to the forward price at that time.

The shrinkage provider should be required to hold system entry capacity and pay entry capacity (and overrun charges) where appropriate. As the price was set on the basis of forward prices at the NBP (and not at the beach), it would have included an allowance associated with entry capacity costs. The reference price and existing incentive scheme therefore contains an allowance associated with entry capacity costs.

In August, Transco raised modification proposal 0579 "Facilitation of Shrinkage Provide to make NBP Trade Disposals". This proposal would, if implemented, allow the Shrinkage Provider to dispose of gas at the NBP. Transco argue that this would improve the economic and efficient operation of the pipeline system by increasing the ability of the Shrinkage Provide to manage imbalance risk. This modification would, if implemented, exacerbate the problem identified. Transco would be able, as shrinkage provider, to procure gas at the beach and then sell it at the NBP without incurring any entry or commodity charges. This would allow Transco to buy gas at the beach and sell at the NBP profitably by avoiding charges. It would be very difficult for shippers and Ofgem to effectively police Transco's conduct to ensure that this was not occurring at the margin.

AEP Energy Services recently raised modification proposal 0594 "Obligation on the shrinkage provider to acquire system entry capacity. At recent workstream discussions, concern was expressed about the proposed modification and it was agreed that it needed further development. Shippers expressed concern about potential conflicts of interest given Transco's role in selling entry capacity. Further development will inevitably slow the date at which this modification could be implemented.

AEP continue to believe that this issue needs urgent resolution. The current arrangements are inefficient and are inconsistent with the intent of Ofgem's incentive arrangements. Ofgem, in setting Transco's SO incentives gave Transco an allowance for acquiring shrinkage gas based on NBP prices. Transco is able, under the current rules, to acquire gas without incurring any capacity or commodity charges. Transco will therefore benefit under its incentive regime as a result of the current rules and not as a result of any efficiency improvements in acquiring shrinkage. Shippers and customers will pay for these windfall gains to Transco. Transco has already accrued 7 months of benefit under its SO incentive scheme. Shippers need to be assured that Transco will, in managing shrinkage, have incentives to operate efficiently this winter. Annual shrinkage volumes for the current formula year are 8.2TWh and target costs are £60m. The value of the benefit of free capacity to Transco could, therefore, be very significant. The potential distortions and costs to shippers and customers associated with Transco bringing on gas for shrinkage purposes at constrained terminals (as Transco does not face the costs of entry capacity and may not, under the buy back incentive, be fully exposed to any resulting buy back costs) could also be significant.

AEP has therefore suggested another modification that can be implemented quickly whilst the industry and customers consider more enduring solutions to the problem identified. This modification would only allow Transco, as shrinkage provider, to take delivery of gas at the NBP. As Transco would be acquiring gas at the NBP, the price would reflect entry capacity and commodity costs incurred by the shipper selling the gas to Transco. This would ensure that Transco's incentives operate as intended but would not require Transco to acquire system entry capacity.

Transco, as shrinkage provider, would continue to enjoy flexibility in determining how it procures shrinkage gas but wherever it acquires gas for shrinkage purposes, delivery would be deemed to be at the NBP (even if Transco specified the delivery point as part of any agreement).

To the extent that Transco has contracts in place for the purchase of gas for shrinkage purposes, Transco would have to re-negotiate these arrangements so that any gas delivered was deemed to be delivered at the NBP. The seller would then become responsible for any relevant charges and would be likely to seek to recover these additional costs from Transco in any re-negotiation.

Nature of Proposal

The Shrinkage Provider will be deemed to have acquired all gas at the NBP for the purposes of managing shrinkage.

Purpose of Proposal

This modification would, if implemented, better facilitate the relevant objectives of the efficient and economic operation of the pipeline system. Transco would face the full costs (commodity and capacity) associated with procuring shrinkage gas. This will lead to more efficient system operation.

Consequence of not making this change

Transco would continue to have a strong incentive for inefficient system operation. This would lead to payments from shippers to Transco under the incentive scheme not related to improved performance. This could also lead to higher constraint costs that would ultimately be paid for by shippers and customers.

Area of Network Code Concerned

Section N

Proposer's Representative

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Proposer

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Signature

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