TRANSCO NETWORK CODE MODIFICATION PROPOSAL No. 0592

"Change to the mechanism for recovering the costs of locational balancing actions "
Version 2.0

Date: 18/10/2002

Proposed Implementation Date: 31/10/2002

Urgency: Urgent

Justification

Under current Network Code rules, Transco is able to take balancing actions for delivery at specific locations (entry or exit) on the NTS. Transco can use the locational market on the OCM, operated by EnMO, or under its new commercial freedom as SO, could also trade OTC for delivery at specific locations.

Balancing actions taken in locational markets are excluded when calculating imbalance cash out prices. The costs associated with locational balancing actions are recovered from Users through balancing neutrality.

All locational balancing actions that are taken at prices in excess of prevailing NBP prices are, by definition, associated with transportation constraints. If Transco has a deficit of surplus of gas in a particular location and must buy (or sell) gas at the location at a premium (or discount) to the prevailing market price, then this cost is associated with constraints on the transportation system. Transco can therefore take locational balancing actions as an alternative commercial tool to entry capacity buy backs and/or issuing TFAs (where compensation may be due).

Transco has agreed to incentive arrangements as part of the introduction of new SO incentives from April 2002. Transco has exit and entry incentives to manage the costs of transportation constraints on the day. These form an important part of Transco's new investment incentives to develop and maintain an economic and efficient NTS to meet the need of its customers over the longer term.

The current Network Code rules create a significant distortion in the new arrangements and appear to be inconsistent with the intent of Ofgem's NTS SO incentive arrangements. The anomalous situation where the costs associated with locational actions do not form part of Transco's incentives would appear to be an oversight.

Ofgem, Transco and shippers have always agreed that locational energy actions can be used as an alternative to other capacity-based commercial tools. Transco has always argued that it should be able to use these tools where it would be more efficient that using capacity based tools. AEP strongly supports this view but believes that Transco must face the same cost incentives on locational balancing action costs as those faced under the buy back and exit incentive.

Ofgem's position in the discussions and consultations leading up to the introduction of the New Gas Trading arrangements in 1999 was always that the cost of locational balancing actions should be included in any buy-back incentive (see for example the September 1999 NGTA decision document). The failure to address this issue either through subsequent regime developments and the introduction of the SO incentives would appear to be an oversight.

As locational actions are a substitute for capacity actions, in the absence of a rule change Transco has a perverse incentive to use locational actions in preference to buy back actions, irrespective of the relative costs. This is because Transco is exposed to the costs of capacity based actions under its incentives but not the costs of locational actions. This is likely to lead to inefficient system operation, as Transco will not necessarily use the most effective tool. It will also potentially lead to inefficient investment over the medium term, as Transco will not be exposed to constrain costs in the manner intended by Ofgem.

The current position in gas is also inconsistent with the arrangements under NGC's SO incentive scheme where locational energy purchases and sales form part of NGC's incentive targets.

AEP therefore believes that the current Network Code rules represent an oversight and are in need of urgent modification to ensure efficient system operation and that Transco's SO incentives have their intended effect. Transco has recently used the locational market (at a cost of (c£265,000) on a day when buy back actions were taken and the price of capacity at constrained terminals was significant. Without an urgent change to the rules, Transco will continue to be able to use the locational market in preference to capacity tools irrespective of the cost to shippers and ultimately customers. This will have a significant commercial impact on shippers and customers until the current anomaly is addressed.

Nature of Proposal

Transco will pay the full cost of any Market Balancing Buy or Sell Action for the purposes of increasing or decreasing gas flows at a System Point for the purposes of avoiding or remedying a Localised Transportation Deficit.

At the end of the year, Transco will add these costs to level of costs under the SO entry capacity buy back incentive and will then determine the payment due to (or from) Transco under the sharing factors, caps/collars and target costs set out in the licence with all locational action costs deemed to be buy back costs. To the extent that Transco has overpaid over the course of the year, any shortfall should be recovered through an adjustment to the SO commodity charge.

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 of transportation constraints under the relevant incentive schemes. This will lead to more efficient system operation and development of the system.

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. This could also lead to inefficient investment in the network over the medium term. It could also undermine the proposed auctions of long term capacity.

Area of Network Code Concerned

Section F

Proposer's Representative

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Proposer

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Signature

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