Draft Modification Report
Obligation on the shrinkage provider to acquire system entry capacity
Modification Reference Number 0594

Version 1.0

This Draft Modification Report is made pursuant to Rule 8.9 of the Modification Rules and follows the format required under Rule 8.9.3.

1. The Modification Proposal

The Proposer has stated that :

"Under current Network Code rules, the Shrinkage Provider is not required to apply or hold System Capacity or to pay capacity 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.

The current Network Code arrangements are inefficient and are inconsistent with Transco's licence obligation to operate an economic and efficient pipeline system and they distort Transco's incentives.

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, therefore, be required to hold system entry capacity and pay entry capacity (and if appropriate 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.

If Transco does not pay entry capacity costs, it will lead to payments under the incentive scheme that are not associated with efficiently procuring gas as Shrinkage Provider. It could also distort Transco's incentives to operate efficiently. Transco, when procuring shrinkage gas and utilizing existing contracts to procure gas, should face the total cost (including entry capacity costs).

This proposal merits urgent status. Transco will already have accrued 6 months of benefit under its SO incentive scheme because of an anomaly in the Network Code rules. 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. As the benefits are accruing daily, and the costs could escalate rapidly during a period of entry constraints, AEP believes that this proposal merits urgent status.

Although MSEC has already been sold this winter, Transco can purchase entry capacity for shrinkage purposes in secondary markets and/or RMSEC, DSEC and Interruptible auctions."

2. Transco's Opinion

Transco does not support implementation of this Modification Proposal.

Transco considers that its Licence obligations provide appropriate incentives to efficiently manage the procurement and operation of the Shrinkage Provider (SP) account. These incentives arise from the Licence conditions that define the LDZ price controls as well as the SO incentive arrangements, particularly the system balancing incentive.

Transco believes that the recently agreed modifications to its Gas Transporter (GT) Licence, that took effect from the 1st April 2002, were proposed by Ofgem on the basis of continuation of the existing Network Code terms relating to the operation of the SP account. Transco is not aware of any suggestion in Ofgem's consultation and proposal papers that a change to the arrangements was contemplated, and Transco's information provision regarding cost projections and subsequent acceptance of the Licence modification proposal was also on the basis of continuation of the existing Network Code terms. It is therefore Transco's view that implementation of this Modification Proposal would be inconsistent with the SP assumptions which underpin the Licence arrangements in respect of the LDZ price control and SO incentives.

Transco does not believe that implementation of this Modification Proposal would further the relevant objectives of the Network Code.

The SP has procured gas at both the beach and the NBP. The SP can bring gas onto the System without needing to hold System Entry Capacity. However when the SP has procured gas at the beach the contractual terms have provided Transco with flexibility to ensure that gas flows are removed from a beach terminal before capacity management tools are deployed close to gas flows. This reflects the business rules agreed with the community in July 1994 that have underpinned the Network Code and three successive Transco price control settlements. Thus Transco considers that the current Network Code terms, and the combination of operational procedures and procurement activities have always ensured the economic, efficient and co-ordinated operation of the System.

Transco has already procured some beach gas arrangements with the flexibility defined in the previous paragraph. Such arrangements currently ensure efficient gas flow management but under this proposal might induce inefficient capacity purchases by Transco to manage potential exposures. If this modification were implemented it might be necessary to make arrangements for Transco to participate in QSEC, MSEC, day ahead or within day primary auctions and Transco would welcome User views on the desirability of this.

Implementation of this Modification Proposal may increase the cost of SP account operation. Any additional costs for LDZ shrinkage procurement would be a direct cost to Transco. Under the NTS SO system balancing incentive scheme, additional costs incurred in the operation of the SP account would be borne predominately by Users. In addition, implementation of this Modification Proposal could have implications across other SO incentive schemes. In particular, Transco believes that implementation might increase the demand for capacity. Revenue from additional capacity sales could impact both the capacity buy-back incentive scheme and the entry investment incentive scheme, providing a financial benefit to Transco.

Transco notes that it has been suggested by the Proposer that, if implemented, the Proposal would strengthen the incentives on Transco to operate the SP account more efficiently. Transco's view is that placing an additional requirement to secure entry capacity or pay entry overruns would not be expected to improve efficiency of SP account operation. Transco would welcome views from respondents as to how implementation of this Modification Proposal might promote greater efficiency of the SP account and of potential impacts in respect of the relevant objectives and other SO and LDZ incentive areas.

Transco has considered the possible interactions between the gas and electricity regimes and has concluded that there would be no impact on the electricity regime if this Modification Proposal was implemented. However, respondents' views on any potential interactions would be welcomed.

3. Extent to which the proposed modification would better facilitate the relevant objectives

The Proposer argues that implementation of this Modification would ensure that Transco would face the full commodity and entry capacity costs associated with procuring Shrinkage gas; this will lead to more efficient system operation thereby better facilitating the relevant objective of the efficient and economic operation of the pipeline system.

Transco does not accept the above position and has argued to the contrary in the above section of this report.

4. The implications for Transco of implementing the Modification Proposal , including

a) implications for the operation of the System:

Transco believes that the current arrangements provide for efficient flow management on the System when gas flows imply an imminent firm capacity shortfall. This arises because of the SP beach gas contractual terms which ensure the timely and precise quantity to be delivered at the chosen location. Implementation of this Modification Proposal would require Transco to procure System Entry Capacity (or face Overrun exposure) in respect of all gas delivered onto the System for the SP account. This would increase costs for the SP account and may influence the pattern of gas flows on the System. However, the precise impacts are uncertain since such requirements may exacerbate both the frequency and extent of the requirement for prompt buy-back actions or alternatively may actually generate incremental capacity purchases into which no gas flows.

On balance, Transco believes that implementation of this Modification Proposal is likely to detract from the economic and efficient operation of the System.

b) development and capital cost and operating cost implications:

Transco would not envisage any development or capital cost implications to arise. However Transco believes the intent of the Proposer is to increase the operating costs associated with the SP account.

c) extent to which it is appropriate for Transco to recover the costs, and proposal for the most appropriate way for Transco to recover the costs:

Some of the possible increased costs may be shared with Users in accordance with the relevant SO Incentive scheme. Other increased costs would act to the detriment of Transco's LDZ performance.

d) analysis of the consequences (if any) this proposal would have on price regulation:

Transco believes that implementation of this Modification Proposal would constitute a change to the assumptions underpinning the Licence modifications agreed during 2002. If implemented prior to the expected expiry of the current arrangements in March 2007, Transco believes it would be appropriate for modifications to be made to its Licence conditions in order to reflect the significant change in assumptions.

5. The consequence of implementing the Modification Proposal on the level of contractual risk to Transco under the Network Code as modified by the Modification Proposal

Transco currently has arrangements in place for beach gas deliveries for SP purchases for the 2003/4 formula year. Implementation of this Modification Proposal would therefore create an unanticipated requirement for capacity.

6. The development implications and other implications for computer systems of Transco and related computer systems of Users

No development issues are envisaged.

7. The implications of implementing the Modification Proposal for Users

Implementation of this Modification Proposal might be expected to lead to changes in underlying costs and incentive performances. These may impact Users in accordance with the relevant SO incentive schemes.

8. The implications of implementing the Modification Proposal for Terminal Operators,Consumers, Connected System Operators, Suppliers, producers and, any Non-Network Code Party

No direct implications are envisaged.

9. Consequences on the legislative and regulatory obligations and contractual relationships of Transco and each User and Non-Network Code Party of implementing the Modification Proposal

Transco is not aware of any impact on legislative and regulatory obligations.

10. Analysis of any advantages or disadvantages of implementation of the Modification Proposal

Advantages:
Transco will be required to pay entry capacity (and overrun charges, if appropriate) therefore aligning costs with the NBP forward price target.

Transco would face the full costs of (commodity and capacity) associated with procuring shrinkage gas, which might promote more efficient system operation.

Disadvantages:
May lead to increased costs for both Shippers and Transco.
Seeks to change the basis of the System Balancing Incentive scheme which is set within Transco's GT Licence.

May lead to increased costs for LDZ shrinkage procurement
Transco may be required to renegotiate beach gas trade deals in order to reflect revised capacity arrangements.

11. Summary of the Representations (to the extent that the import of those representations are not reflected elsewhere in the Modification Report)

Representations are sought as part of the Draft Modification Report.

12. The extent to which the implementation is required to enable Transco to facilitate compliance with safety or other legislation

No such requirement exists in respect of the Modification Proposal.

13. The extent to which the implementation is required having regard to any proposed change in the methodology established under Standard Condition 4(5) or the statement furnished by Transco under Standard Condition 4(1) of the Licence

No such requirement exists in respect of the Modification Proposal.

14. Programme of works required as a consequence of implementing the ModificationProposal

No specific programme of works is anticipated.

15. Proposed implementation timetable (including timetable for any necessary information systems changes)

The development of an implementation timetable is subject to the Ofgem decision on the Proposal.

16. Recommendation concerning the implementation of the Modification Proposal

Transco does not recommend implementation.

17. Text

Representations are now sought in respect of this Draft Report and prior to Transco finalising the Report

Signed for and on behalf of Transco.

Signature:

Tim Davis
Head of Regulation NT&T

Date: