Draft Modification Report
Obligation on shrinkage provider to purchase gas at the NBP
Modification Reference Number 0599

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 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."

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 does not believe that this Modification Proposal would better promote economic and efficient operation of the System. If implemented, the supplier of any beach gas contracted to the SP would need to secure entry capacity to enable transfer of such gas to the SP. This would artificially increase the demand for capacity, potentially exacerbating the risks of constraints that require capacity management tool deployment close to gas flow. Thus the proposed restriction in the SP arrangements might be expected to reduce the efficient outcome that the combination of Transco's contractual terms and operational procedures deliver to the community.

Transco also believes that implementation of this Modification Proposal could prove to be damaging to competition between Shippers. Transco would prefer to be able to honour contractual commitments made with counterparties. Implementation of Modification Proposals such as this could undermine the confidence of market players. To date Transco has already procured, from a number of Users, a proportion of the SP requirement for the 2003/4 formula year. Some of this gas has been procured at the beach, under terms that Transco believes ensure that such purchases must be considered consistent with the economic, efficient and co-ordinated operation of the System. Implementation of this Modification Proposal would be inconsistent with the terms of those trades, effectively creating an essential requirement to renegotiate their terms. Transco believes that implementation of this Modification Proposal would therefore undermine User confidence in transacting with Transco thereby undermining competition between Shippers in respect of the provision of services to Transco. Furthermore, the increased risks, to Users, posed by such contractual changes may lead to increased costs for future contract arrangements with Transco.

Transco also believes that implementation of this Modification Proposal would be inconsistent with the intent of the recent Licence modifications that were designed to allow Transco commercial freedom to respond to the various SO incentive schemes and other obligations. This Modification Proposal specifically seeks to limit the SP procurement of gas to the NBP. This limits SP activity so that outcomes arising from the procurement of beach gas would not be permitted regardless of whether this is the most economic and efficient approach. Transco believes that such artificial constraints on its approach to purchasing would not be in the interests of customers, which Ofgem sought to align with Transco's interests through the structure of the SO incentive schemes.

Implementation of this Modification Proposal may increase the cost of SP gas procurement. 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 procurement of NTS Shrinkage 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 would 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 restricting the available options 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 with the electricity regime 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 Users to procure System Entry Capacity (or face Overrun exposure) in respect of all gas delivered on behalf of the SP. This would increase costs for such Users 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 decrease certainty about the location and timing of gas flows on the System and so might be expected to have modest adverse consequences for the 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 inconsistency between those arrangements and the Network Code.

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

No development issues are envisaged. Transco would welcome views as to whether there might be any impacts in respect of the related computer systems of Users.

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: (Identified by Proposer)

By exposing Transco to the full costs of Shrinkage Procurement the Proposer believes that Transco will be more strongly incentivised to operate the Shrinkage Provider account more efficiently.

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 create a requirement to renegotiate beach gas trade deals.

May seek to undermine User confidence in transacting with Transco in the light of regulatory uncertainty.

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: