Shippers, Transco and Other Interested Parties

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Dear Colleague,

Network Code Modification Proposal 0579 "Facilitation of Shrinkage Provider to make NBP Trade Disposals"

Ofgem has considered the issues raised in network code modification proposal 0579 *'Facilitation of Shrinkage Provider to make NBP Trade Disposals'*. Ofgem has decided to direct Transco to implement the modification because we consider that this proposal will better facilitate the relevant objectives of Transco's network code under Standard Condition 9 of Transco's Gas Transporter licence.

In this letter, we explain the background to the modification proposal and give the reasons for making our decision.

Background to the proposal

As the national transmission system (NTS) system operator (SO), Transco is responsible for the efficient day-to-day operation of the NTS. In undertaking this role, Transco is responsible for undertaking efficient residual supply and demand matching to keep the NTS in balance, ensuring the efficient management and use of its existing pipeline capacity and ensuring the security and quality of supplies of gas including the management of shrinkage.

Shrinkage

Shrinkage gas includes gas lost through leakage and theft as well as gas that is used as fuel for NTS compressors. The costs of shrinkage can be influenced by Transco's actions as NTS SO and, as such, Transco is incentivised under its NTS SO incentives to manage shrinkage gas costs effectively. Under Transco's SO incentives for the period 1 April 2002 to 31 March 2007, Transco receives a fixed allowance for SO gas costs, otherwise known as shrinkage[1].

The shrinkage gas component of Transco's incentives comprises a target level of NTS SO gas costs for own use gas[2], unaccounted for gas[3], and unbilled energy[4]. The targets have been set for two years using Transco's forecast of the volumes of required shrinkage gas. These forecast volumes were multiplied by a price of gas derived using current forward prices for National Balancing Point (NBP) gas. The target cost levels have been set at £59.5m for 2002/3 and £59.7m for 2003/4.

Under the incentive, if Transco performs better (worse) than the target it bears 25(20)% of the difference. A cap of £4million and a collar of -£3million limits Transco's exposure under this incentive. NTS shrinkage gas costs are then reflected in the SO commodity charge.

Increased contracting freedoms

As part of the development of Transco's SO incentives, Transco has been given greater discretion in procuring services for the purposes of system balancing, capacity management and residual gas balancing. For example, in the case of entry capacity management Transco is now able to enter into forwards and options contracts for purchasing entry capacity well ahead of the gas day.

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[1] Transco's SO incentives for April 2002 to March 2007 were implemented via modifications to Transco's GT licence on 27 September 2002 with effect from 1 April 2002.

[2] Own use gas includes gas used for compression, venting and preheating.

[3] Unaccounted for gas arises from meter inaccuracies and discrepancies between measured flows and actual physical flows leading to differences in measured NTS entry and exit volumes.

[4] Unbilled energy is the result of differences between the actual calorific value of gas delivered onto the NTS and the average (flow weighted) calorific value upon which billing is based.

As a consequence of this increased freedom, Transco has been required to prepare Procurement Guidelines and System Management Principles statements. These statements are intended to aid transparency for market participants regarding the services that Transco is contracting for as well as to assist market participants in better understanding the principles that Transco will adopt in balancing the NTS.

Ofgem approved the form of both of the Procurement Guidelines and System Management Principles Statement in September 2002. It is noted that, in approving the form of the Procurement Guidelines, Ofgem raised concerns that the document should contain more detail on the nature of the information that Transco intends to publish regarding the results of procuring system management services, such as gas for shrinkage purposes.

Related modification proposals

In light of the recent developments of Transco NTS SO incentives, on 25 October 2002, AEP Energy Services Ltd. (AEP) raised modification proposal 594 *'Obligation on the shrinkage provider to acquire system entry capacity'.* The purpose of the modification was to require the shrinkage provider to pay for the full cost (including all relevant transportation charges) of shrinkage gas.

On 11 November 2002, AEP raised modification proposal 599 *'Obligation on shrinkage provider to purchase gas at the NBP'*, which proposed that all shrinkage gas be procured by Transco at the NBP.

Both these proposals are currently being consulted upon.

The proposal

Network code modification proposal 579 proposes to allow the shrinkage provider to make disposing trade nominations up to a limit determined by the aggregate quantities of acquiring trade nominations for the gas day.

Respondents' views

There were seven responses to the modification proposal. A majority of respondents did not support the proposal. Most of the respondents in favour of the proposal provided qualified support.

Some respondents recognised that Transco should have greater flexibility to manage its shrinkage account efficiently, hence lowering shrinkage costs. These respondents accepted that the shrinkage provider should be able to make sales at the NBP. In this context, one respondent stated that, without a symmetric ability for the shrinkage provider to purchase and sell gas, Transco might have an incentive to underestimate the shrinkage requirement for a day. Another respondent stated that allowing Transco to make sales should improve the efficiency of Transco's procurement and reduce an asymmetry in the risk it faces.

Several respondents commented about the need for transparency and more information regarding the activities of the shrinkage provider. One respondent stated that Transco should be required to provide more detailed information on the operation of the shrinkage account, including volumes of gas procured and sold, the means of procurement (i.e. whether the gas was bought at the NBP, at the beach, on the day or with longer term contract), and a monthly weighted average price paid.

A number of respondents were concerned about the effects of Transco's disposals of shrinkage gas on market prices and suggested some limitations on Transco's flexibility. These proposed limitations included an obligation on Transco to base its shrinkage nominations on its best unbiased estimate of shrinkage requirements for a day, and a provision that the shrinkage provider could only dispose of excessive shrinkage gas on the day when compared to shrinkage requirement as estimated on the day before.

Some respondents expressed their concerns about how the shrinkage provider would exercise its new discretion, how it would impact Transco's incentives, and the extent to which Transco could undertake speculative trading by over-purchasing shrinkage gas, expecting the gas price to increase, then selling it later at a profit thereby benefiting under its incentives. In this respect a number of respondents opposed to the proposal raised concerns regarding the level of information published by Transco with one respondent stating that further information would allow shippers to have more comfort that the shrinkage provider was not undertaking speculative trading.

One respondent stated that this modification proposal required more analysis and the resolution of modification proposal 594. Another respondent stated that if the shrinkage rules were changed to address some of the anomalies in the current arrangements (namely the shrinkage provider's relief from paying transportation charges), it would support Transco having complete freedom to acquire and sell gas for the purposes of managing its shrinkage account. A respondent also recommended that, given the significant number of recent shrinkage-related modification proposals, a comprehensive review of shrinkage rules within Transco's network code be undertaken.

A respondent added that any trading activity under the shrinkage account should be confined to a regulated, cleared and anonymous trading system.

Transco's view

Transco stated that implementation of the proposal would remove an asymmetric feature of the current arrangements that could give Transco an incentive to under-deliver gas into the shrinkage provider account, particularly in respect of ahead of day and early within day nominations.

Transco added that revenue arising from the sales of shrinkage gas would be a negative cost for the purpose of determining the NTS SO gas cost performance measure. Therefore, the implementation of this proposal would help reduce costs for Transco and the users in accordance with the SO incentive parameters. Transco also stated that this modification proposal, by allowing Transco to dispose of any excess shrinkage gas, would potentially provide extra liquidity in the NBP market.

Transco stated that it would be inappropriate to procure shrinkage gas at the beach in excess of that required to balance the shrinkage account and subsequently sell any excess gas at the NBP. For this reason, the proposal includes the restriction that the quantity of gas which is the subject of disposing NBP trades must be less than or equal to the quantity associated with NBP trade acquisitions for that gas day.

Transco maintained that additional reporting of information about the shrinkage account to the users would reveal commercial strategies to the detriment of the efficient operation of the shrinkage provider account. It stated that the release of such information should be at Transco's discretion in light of commercial confidentiality considerations. Transco noted that it is required to report to Ofgem about its shrinkage account activities and that its licence provisions should be sufficient to ensure that Transco is not acting inappropriately in its role as shrinkage provider.

Ofgem's view

Ofgem believes that this modification proposal would give Transco more flexibility to respond to its NTS SO gas costs incentive and therefore to manage its shrinkage account more efficiently. In particular, the current inability of Transco to sell excess shrinkage gas restricts its capacity to enter into more flexible contractual arrangements ahead of the gas day as it is unable to trade out any discrepancy with actual daily shrinkage requirements. Ofgem considers that the inability to sell gas represents an impediment to more flexible contracting ahead of the gas day. The removal of this impediment should assist in reducing the costs of shrinkage management thereby facilitating efficient system operation.

Ofgem accepts the concerns raised by respondents regarding the need for more transparency with respect to the procurement of shrinkage gas. As was outlined in our decision letter of 11 October on Transco's Procurement Guidelines and reiterated in our decision letter on Modification 587, *'Prospective publication of further forward and option capacity information',* Ofgem considers that, as with NGC, there should be a greater expectation of transparency with respect to Transco's activities given its role as monopoly system operator. In Ofgem's view the need for transparency is even more important given Transco's increased contracting freedoms and participation in forwards markets.

In this respect Ofgem believes that Transco should ensure that it releases information[5] concerning the procurement and sale of shrinkage gas through its Procurement Guidelines including volume and weighted average price information. The publication of this information should aid market transparency and assist shippers in monitoring Transco's performance under its SO incentives. Ofgem would also note that shippers have a role in monitoring Transco's conduct against

[5]In addition to Transco changing its Procurement Guidelines, it is open to shippers to raise network code modification proposals to improve the transparency of Transco's procurement activities.

its licence obligations including its prohibited procurement activities and efficient operation licence conditions. The publication of information should assist shippers in this respect.

Ofgem does not believe that the reporting of information of this nature would be detrimental to the efficient operation of the shrinkage provider. Indeed, the publication of this information should benefit Transco by facilitating competition in the provision of shrinkage services.

As an additional point, Ofgem would note that, as part of its normal market monitoring role, it intends to closely monitor Transco's procurement activities under the shrinkage provider account.

Ofgem also considers that this proposal will bring about greater alignment between the information provided in the gas and electricity sectors, given NGC's practice of publishing information on its trading activities for the purpose of balancing services on a daily basis on its information website.

Ofgem's decision

For the reasons outlined above, Ofgem has decided to consent to this modification, as we believe that it better facilitates the achievement of the relevant objectives as outlined under Amended Standard Condition 9 of Transco's GT licence. In particular, Ofgem believes that this modification proposal should better facilitate the economic and efficient operation of Transco's pipeline system by providing Transco with greater contracting freedom in procuring shrinkage gas.

If you have any queries in relation to the issues raised in this letter, please feel free to contact me on the above number or Samanta Padalino on extension 7033.

Yours sincerely,

Mark Feather
Head of New Gas Trading Arrangements