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Dear Colleague,

Network code modification proposal 0594 *"Obligation on the shrinkage provider to acquire system entry capacity"* and network code modification proposal 0599 *"Obligation on shrinkage provider to purchase gas at the NBP"*

Ofgem has carefully considered the issues raised in network code modification proposal 0594 *"Obligation on the shrinkage provider to acquire system entry capacity"* and modification proposal 0599 *"Obligation on shrinkage provider to purchase gas at the NBP"*.

Ofgem has decided to direct Transco not to implement modification proposal 0594 because it does not believe that this proposal would better facilitate the relevant objectives of Transco's network code under amended standard condition 9 of Transco's Gas Transporter (GT) licence.

Ofgem has decided to direct Transco to implement modification proposal 0599, from 1 April 2004, because it considers that the proposal will better facilitate the relevant objectives of Transco's network code under amended standard condition 9 of Transco's GT licence.

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

Background to the proposals

As the national transmission system (NTS) system operator (SO), Transco is responsible for the efficient day-to-day operation of the NTS. As part of this role, Transco is responsible for efficiently

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matching residual supply and demand to keep the NTS in balance, operating its existing pipeline capacity in an efficient manner, and ensuring the security and quality of gas supplies. This includes the efficient management of gas shrinkage.

Shrinkage

Shrinkage gas is gas lost through the transportation system at the local distribution zone (LDZ) and NTS level. LDZ gas shrinkage is gas lost through leakage, theft as well as gas that is used for operational reasons. NTS shrinkage gas comprises own use gas[1], unaccounted for gas[2], and unbilled energy[3].

The costs of shrinkage can be influenced by Transco's actions as NTS SO and, as such, Transco has financial incentives to manage NTS shrinkage gas costs effectively. Under Transco's NTS System Operator (SO) incentives for the period 1 April 2002 to 31 March 2007, Transco receives an allowance for SO gas costs, otherwise known as shrinkage[4]. These incentives are set out in Transco's GT's licence.

Under these arrangements, Transco has an incentive target set for two years. The target was set using Transco's forecast of the volumes of required shrinkage gas. These forecast volumes were then multiplied by a price of gas derived using current forward prices for national balancing point (NBP) gas to derive a target. A premium was added to the forward prices to take account of short-term uncertainties faced by Transco in procuring shrinkage gas.

Transco also faces target gas volumes for the final three years of the price control (from 1 April 2004 to 31 March 2007). During this three year period Transco's cost target is set by multiplying these volumes by an NTS SO gas cost reference price that is determined using a formula set out in Transco's GT licence to take account of future forward prices.

Under the incentive, if Transco performs better (worse) than the target[5] it bears 25(20)% of the difference. A cap of £4million and a

[1] Own use gas includes gas used for compression, venting and preheating.
[2] 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.
[3] 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.
[4] Transco's SO incentives for April 2002 to March 2007 were implemented on 27 September 2002 with effect from 1 April 2002.
[5] The target cost levels have been set at £59.5m for 2002/3 and £59.7m for 2003/4.

collar of -£3million limits Transco's exposure under this incentive. Any balance is borne by shippers through the SO commodity charge. The sharing factors and caps and collars have been set for 2 years and will be reviewed this year for the period commencing 1 April 2004.

Gas procured for shrinkage purposes is accounted for separately under Transco's shrinkage provider (SP) account. Under the network code, the shrinkage provider is treated as a user. However, it is currently not required to hold system capacity rights or to pay for capacity and commodity charges. Transco's SP account is also exempted from paying balancing neutrality charges, overrun charges or scheduling charges.[6]

In 1995, Transco entered into a long term bilateral contract with British Gas Trading to purchase shrinkage gas at the beach. This contract is due to expire in September 2005. From 1 October 2002, Transco has put in place additional arrangements with other counterparties to meet its shrinkage gas requirements.

Related modification proposals on shrinkage

In January 2003, Ofgem approved network code modification proposal 0579 *"Facilitation of Shrinkage Provider to make NBP Trade Disposals".* The modification allowed Transco to sell shrinkage gas at the NBP up to a limit determined by the aggregate acquisitions of shrinkage gas at the NBP on a day.

In February 2003, London Electricity raised modification proposal 618 *"Publication of shrinkage provider gas procurement and disposal information'*. The proposal seeks Ofgem's approval to require Transco to publish detailed information about Transco's trading activities under the shrinkage provider account. Ofgem has now received the final modification report for this proposal and expects to release its decision shortly.

The entry capacity regime

Transco has allocated access rights to the NTS via six-monthly auctions of monthly system entry capacity (MSEC) since September 1999. In addition, following Ofgem's approval of modification 0500 *"Long Term Capacity Allocation"* Transco now makes available quarterly system entry capacity (QSEC) rights to access the NTS up to 15 years ahead of use through long term entry capacity auctions. The first long term auction took place in January 2003.

[6] Transco has indicated that due to an error in the legal drafting of modification 479 '*Incentivised Nomination Scheme (INS)'* the shrinkage provider account is currently subject to INS charges.

In addition to providing MSEC and QSEC, Transco releases daily firm system entry capacity (DSEC) on a day-ahead and within-day basis. Transco also releases a use-it-or-lose-it (UIOLI) interruptible capacity product on a day-ahead basis. This product is intended to prevent the hoarding of firm entry capacity rights by shippers.

In the event that expected flows exceed both the capability of the system at an entry point and the amount of capacity held by shippers at that terminal, Transco must act to reduce the amount of available capacity. This achieved in the first instance through the scaling back of interruptible capacity and subsequently by the purchase, by Transco, of firm entry capacity rights from shippers at market determined prices. In this context Transco is now free to contract for capacity ahead of the day with a view to reducing the total costs of capacity management.

Transco also has financial incentives to manage efficiently the costs of entry capacity buy-backs. Under these incentives (included in its GT licence), Transco faced an £35 million annual target level for the period 1 April 2002 to 31 March 2003 and a £10-20 million target for 1 April 2003 to 31 March 2004. Transco is rewarded for performance below target and penalised for performance above target. Transco's potential revenues and costs under this incentive are subject to sharing factors as well as caps and collars that have been set for the first two years of the price control for the period 1 April 2002 to 31 March 2007. The upside (downside) sharing factors are set at 50%(35%). The cap is £30 million and the collar is set at £12.5 million. These incentive parameters will be reviewed prior to 1 April 2004.

The proposals

Network code modification proposal 0594 "Obligation on the shrinkage provider to acquire system entry capacity"

Network code modification proposal 0594 proposes that Transco be required as the SP to hold system entry capacity and to pay all entry capacity charges (and overruns) where it purchases gas for delivery to the System.

Network code modification proposal 0599 "Obligation on shrinkage provider to purchase gas at the NBP"

Network code modification proposal 599 proposes that Transco as the SP be deemed to have acquired all gas at the NBP for the purposes of managing shrinkage.

Respondents' views

Network code modification proposal 0594 “Obligation on the shrinkage provider to acquire system entry capacity”

There were seven responses. All respondents with the exception of the proposer were opposed to the implementation of this modification proposal.

Several respondents raised concerns that the proposal would imply a substantial change across the industry as Transco may need to participate in entry capacity auctions to procure the entry capacity it needs whilst at the same time receiving other shippers’ bids. Some respondents commented that the implementation of the proposal would require changes to Transco’s internal structure and could distort the operation of the entry capacity market.   One respondent noted that Transco could have a competitive advantage over other participants in the auctions as they would have greater access to information, with another respondent questioning how information flows would be managed. One respondent commented that the proposal may have perverse effects on Transco’s buy-back and entry capacity investment incentives.

One respondent noted the views of the proposer regarding the costs of bringing shrinkage gas onto the NTS at constrained terminals. This respondent stated that the SP currently has the flexibility not to acquire entry capacity at a terminal where management tools may be deployed, thus always flowing shrinkage gas against spare capacity which would otherwise be offered as interruptible with a zero reserve price. As such the respondent indicated that the proposal would merely create a false accounting exercise by requiring the SP to purchase this capacity.

A respondent stated that Transco should be treated on the same basis as shippers and thus be required to hold entry capacity rights to input shrinkage gas bought at the beach. However, in opposing the modification proposal, it noted that the current drafting of the proposal did not contain appropriate safeguards to deal with the problems of having Transco as both capacity owner and capacity purchaser.

A respondent stated that, for the sake of certainty, it was not appropriate to make material changes to Transco’s incentives through the network code, unless such changes were necessary to ensure consistency with Transco’s licence. In this respect, another respondent noted that it would be more relevant to raise the issues discussed as part of this proposal when the incentive target on Transco’s shrinkage gas costs is reviewed.

Finally, several respondents stated that there was the need of a thorough review of the role and activities of Transco as SP.

Network code modification proposal 0599 “Obligation on shrinkage provider to purchase gas at the NBP”

There were seven responses. Two respondents were in favour of the proposal, two provided qualified support and three expressed their opposition to its implementation.

Some respondents, in criticising the proposal, commented that Transco should be allowed to procure gas from the most economic and efficient source (beach or NBP) with no artificial limitations. Some of these respondents stated that Transco should transact on the same terms as other system users. Other respondents however noted that it is inequitable that the SP can acquire gas at the beach and dispose of surplus gas at the NBP with no requirement to hold the necessary entry capacity rights or pay other relevant transportation charges. In this respect, one respondent noted that it is important to expose Transco to the same trading arrangements and costs as shippers face. Another stated that to allow Transco entry free gas when their incentive is based upon NBP prices could create a distortion in the market and on Transco’s incentives.

One respondent provided support to the proposal as an interim measure to address the perceived inequality between users and the SP and in light of the implementation difficulties associated with modification proposal 0594.

A number of respondents noted that implementation of this proposal would require a renegotiation of the contracts that Transco has currently in place for the procurement of shrinkage gas. One stated that this could undermine effective competition, by reducing the confidence of market participants that contracts with Transco would remain in place as agreed. The respondent stated that re-negotiation adds to costs and the cost of the risk of re-openers in contracts feeds into prices.

Several respondents also highlighted the need for a full review of the shrinkage arrangements.

Transco’s view

Network code modification proposal 0594 “Obligation on the shrinkage provider to acquire system entry capacity”

Transco does not support network code modification proposal 594. In particular, it believes that its implementation would be inconsistent with the assumptions made by Transco in signing the terms of the NTS SO incentives, which were agreed on the basis of a continuation of the existing network code rules with respect to the SP account.

Transco also stated that implementation of this proposal before 2007 would be considered to be a change to the price control settlement. Transco therefore stated that the modification proposal would undermine regulatory certainty.

Transco indicated that the current shrinkage gas procurement arrangements provide the flexibility to move gas flows from a beach terminal before capacity management tools are deployed. Transco stated therefore that it does not need to hold system entry capacity and that this position was reflected in the business rules agreed for shrinkage in 1994. Transco stated that these rules have underpinned the code and three successive price control settlements.

Transco also stated that implementation of this proposal might necessitate capacity purchases or overruns by the shrinkage provider, thus potentially exacerbating constraints at entry. The proposal may then increase the costs of managing shrinkage. These additional costs would be borne by the users in accordance with sharing factors and cap and collar within the NTS SO gas cost incentive and to the extent that any additional costs for LDZ shrinkage procurement would be recovered from users.

As Transco has arrangements in place for beach shrinkage gas delivery for the 2003/04 formula year, implementation of this proposal would create a requirement for capacity or for renegotiating the terms of such arrangements. Transco maintained that this would increase the financial risks faced by the SP.

Transco stated that the proposal would have implications across other incentive regimes and revenue from additional capacity sales could impact both the entry capacity buy-back incentive scheme and the entry capacity investment scheme providing a financial benefit to Transco.

Transco stated that it would welcome a review of the shrinkage arrangements prior to the next price control in 2007.

Network code modification proposal 0599 "Obligation on shrinkage provider to purchase gas at the NBP"

Transco does not support this modification proposal. Transco reiterated its position as outlined in the final report for modification proposal 594 with some additional comments.

Transco added that as it has arrangements in place for beach gas deliveries for the 2003/04 formula year, implementation of network code modification proposal 599 would create an inconsistency between those arrangements and the network code. Further, implementation of modification proposal 599 would require Transco to renegotiate its existing contractual commitments. Transco stated that this would in turn undermine the confidence of market players, increase the risk of transacting with Transco and potentially inflate the costs of future contractual arrangements with Transco.

Transco also stated that this modification proposal is inconsistent with the recent licence amendments since it poses a constraint on the allowed sources of shrinkage gas, thus limiting Transco's commercial freedom to manage gas shrinkage in the most economic and efficient manner.

Ofgem's view

Modification proposals 594 and 599 are intended to address the same concerns about Transco's operation under its shrinkage account, namely the potential for payments to Transco under its NTS gas cost incentive that are unrelated to the efficient procurement and management of shrinkage gas. As these two modification proposals are related, Ofgem has carefully considered which one, if any, would better facilitate the relevant objectives of Transco's network code under standard condition 9 of Transco's licence.

Ofgem acknowledges the concerns that since Transco, as SP, is currently not required to pay for the relevant entry capacity when it inputs gas into the NTS, it could gain under its NTS gas cost incentive by inefficiently procuring shrinkage gas at the beach and subsequently disposing of that gas at the NBP.

Ofgem is concerned that the absence of any requirement to secure entry capacity may impede the efficient management of the shrinkage account. This may create distortions and costs to the extent that shrinkage gas is brought on at constrained terminals where Transco does not face the costs of procuring the entry capacity.

Further, Ofgem does not accept Transco's arguments that its NTS SO incentives were agreed on the basis of a continuation of the existing network code rules with respect to the SP account. Ofgem would note in this context that it approved modification 0579 which allowed Transco to dispose of excess shrinkage gas at the NBP, thus changing the network code rules related to the shrinkage account.

On this basis Ofgem considers that each of these proposals has some merit. However, each proposal also raises a number of difficulties that need to be considered. First, as several respondents have commented, modification proposal 0594 may place Transco as SP in a position of having to secure firm entry capacity via the entry capacity auction process. This raises concerns for Ofgem regarding information flows and the potential for the SP to obtain access to sensitive market and bidder information in the context of the auction process. This could undermine the efficient allocation of entry capacity.

Ofgem notes the concerns that have been raised regarding the interactions of modification 0594 with Transco's entry capacity buy-back incentive. Ofgem shares these concerns and notes that circumstances could arise where, given the sharing factors in each of the SO gas cost and entry capacity buy back regimes, Transco could increase revenues to itself from sales of incremental entry capacity without any associated improvements in performance under its SO gas cost incentive.

Whilst these concerns could potentially be addressed through Transco's obligation to operate its pipeline system in an efficient, economic and coordinated manner, Ofgem believes that they are material to the consideration of this modification proposal and as such, Ofgem is not convinced that the proposal would necessarily better facilitate efficient system operation. Nevertheless, Ofgem intends to consider more closely the potential interaction of Transco's entry capacity buy back and SO gas cost incentives as part of its review of Transco's SO incentives.

In summary, Ofgem considers that the concepts underlying modification proposal 0594 merit further discussions to determine whether it would be possible to address the concerns raised through the consultation process. Nevertheless, in its current form, Ofgem does not believe that modification proposal 0594 better facilitates the relevant objectives.

With regard to modification 0599, Ofgem agrees that the proposal would align Transco's shrinkage gas procurement activity with its NTS SO gas cost incentive. In this respect the proposal would strengthen Transco's incentive to improve the efficient management of gas shrinkage and therefore the efficient operation of Transco's system.

However, Ofgem acknowledges that the implementation of this proposal would require Transco to re-negotiate its present contractual arrangements for shrinkage gas. With this in mind, Ofgem considers that the proposal should be implemented from 1 April 2004 to allow Transco enough time to restructure its contractual arrangements for the procurement of shrinkage gas. Ofgem will monitor Transco's restructuring of its existing arrangements.

Ofgem also recognises the concerns raised by respondents that the proposal would restrict the contracting freedoms granted to Transco under its SO incentives. In this respect, Ofgem would note that there is no barrier to Transco and shippers developing further modification proposals that could enable Transco to secure entry capacity thereby enabling Transco to enter into beach contracts from 1 April 2004. Any such proposals would however need to address the concerns raised above regarding the role of the SP in any auction process.

Ofgem's decision

For the reasons outlined above, Ofgem has decided to consent to modification 0599 and to reject modification proposal 0594, as it believes that only modification 0599 better facilitates the achievement of the relevant objectives as outlined under amended standard condition 9 of Transco's GT licence. In particular, Ofgem considers that modification proposal 0599 will better facilitate the efficient operation of Transco's pipeline system by ensuring that Transco was exposed to the full costs associated with the procurement of shrinkage gas. This modification should be implemented on 1 April 2004 for the reasons outlined above.

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

Yours sincerely,

Kyran Hanks
Director, Gas Trading Arrangements