RGTA Workstream 14th December 2000 2pm 23 Buckingham Gate

The above meeting was convened to further discussion about Modification Proposal 0414 – "Energy Balancing Incentive Redesign". The meeting was held to see if members of the Energy & Capacity Workstream considered that a Development Group report could be written by Transco and then submitted to the Modification Panel to enable a proposal to be sent out for industry consultation.

Summary and key points from the meeting

The meeting reviewed the history of the consideration of this Modification. Key points discussed included:

- Mod 313 had introduced a price based energy incentive, mainly to provide commercial incentives on Transco to avoid extreme priced actions
- The current incentive had delivered the primary objective although many industry players recognised that the current energy incentive regime has limitations :
  - it may discourage Transco from taking an action
  - some believe it may discourage Transco actions on both sides of the market
  - when Transco needs to take action it may encourage actions of a size greater than is strictly necessary from an operational perspective
- The current incentive was recognised as an interim incentive
- In the longer term it may be appropriate to consider an integrated incentive covering both energy and capacity although this is generally considered unachievable in the next year or so
- Transco had therefore raised Modification Proposal 414 to advocate alternative "energy" incentives which might apply in the interim
- Modification Proposal 414 had proposed an incentive based on balancing neutrality costs (ie the net cash flow associated with Transco system balancing, shipper imbalance cashout and scheduling charges) but was designed to facilitate a much wider consideration.
- Transco had circulated a range of incentive ideas in a paper ahead of the 14th June Workstream meeting. These included a range of incentives ranging from the simple incorporation of an additional linepack term through to an incentive scheme that might be based on SMP volatility index measures (which had been developed in response to shipper assertions that Transco actions within day might be impacting the forward curve)
- Workstream meetings noted that the discussion of incentives was inextricably linked to shipper incentives to balance, Transco's role and alternative balancing tools. The workstream could not reach a consensus as a preferred revision to the energy incentive. In particular several shippers believed that Transco's preference for a "balancing neutrality based" incentive could encourage Transco to set wide cash-out prices just to "catch shippers out"
- The community were widely divided on the nature of Transco's role. Many believe that Transco should act as no more than a "residual system balancer"; others believe that Transco should have a pro-active role trading in the market and developing a wide range of alternative balancing tools to deliver "more efficient balancing". Others suggested that

incentives should be dropped and that Transco should be encouraged to participate in the market only under very prescriptive rules.
- Ofgem indicated that incentives on Transco were more likely to generate efficient outcomes compared with prescriptive rules. Ofgem had indicated that it would like to see incentive changes implemented for 1st October and that the incorporation of a linepack term into the energy incentive would be an improvement.

The workstream therefore agreed to suspend further discussions about this Modification until the Ofgem document about future energy balancing regime developments was published. During the summer it was still intended that this document would be produced to enable resumption of Modification Proposal 414 discussions and implementation of a new incentive on 1st October 2000.

The November Modification Panel recently considered the draft Development Group report arising from discussions about Modification Proposal 0433 – "Amendment of System Cash-out Prices". During the November Panel discussion about Modification Proposal 0433 it was suggested that consideration of Modification Proposal 0414 – "Energy Incentive Re-design" should be resumed even though the Ofgem energy balancing regime document had not been published.

The December 2000 Energy and Capacity Workstream therefore reconsidered the above Modification Proposal. Ofgem statements had previously suggested that the introduction of a linepack term would be a beneficial addition to the energy incentive. The workstream therefore considered the introduction of a simple additional term into the current incentive structure. Such a term might have a performance measure calculated as absolute magnitude of either (opening – closing linepack linepack) or (closing – target linepack).

The Workstream discussion also contemplated an incentive structure whereby Transco's performance might be assessed against two different performance measures; one based on a price efficiency term, the other based on some physical system balancing term. Transco's risk reward would then be determined by identifying the worse performance against the two performance measures and then using this to determine the daily incentive credit or debit.

The workstream requested a paper on this proposal and a paper from John Williams was duly circulated to the RGTA circulation list ahead of the 14th December meeting.

The following key points emerged from the discussion at the 14th December meeting:

- The current price incentive is based on both Buys and Sells but the incentive structure is very similar, in effect, to having a single incentive based on the SMP Buy – SMP Sell differential
- There are two likely performance measures that could be used to provide Transco with an incentive to "value" linepack; the absolute value of either (starting – closing linepack) or (closing – target linepack)

Each of these incentives have slightly different merits and may require further consideration before deriving the preferred solution. Starting – closing has the merit that Transco would be encouraged to keep end of day linepack variances day on day as small as possible and therefore may minimise overall costs however some felt that this may deter Transco from gradually building or depleting the line. Closing – target linepack would more strongly encourage Transco to run the system more efficiently from an "operational" perspective (on the assumption that running the system close to target linepack delivers some operational efficiencies).

It was noted that whichever form is chosen it is unlikely to materially affect the operation of the incentive and it was suggested that experience suggested that the average differences in the numeric values derived from the two performance measures were not that great.

It was noted that if the incentive was to be based on target linepack then there would have to be greater transparency about such measures. Some suggested this should be known before the day (and updated if it changed). One shipper suggested that Projected Closing Linepack might be withheld if such an incentive was introduced.

- As an alternative the meeting considered a simple additional additive term for the linepack element that might be incorporated into the current incentive thereby preserving its current structure. With daily caps and collars of £2k (or £4k) and £-15k (Or -£30k) and an opening – closing linepack performance measure then a risk/reward function giving financial benefit to Transco for linepack changes of less than around 3.6 mcm but with costs to Transco when changes exceed such levels would generate a similar financial outcome if last year's performance in respect of all contributory performance measures were repeated. Transco suggested this might be an appropriate formulation to use if introducing such a term.

- John Williams introduced an alternative approach that was based on having two performance measures; price efficiency (SMP Buy – SMP Sell variance expressed as a percentage of SAP) and physical balancing efficiency (measured as actual end of day linepack – target linepack).

  The proposed incentive should then reward/charge Transco on the basis of the worse performance of the two components feeding the Performance Measure. This final of (or "worse of") performance measure would then be used to determine Transco's risk/reward from a single linear function.

  John Williams suggested that before RGTA Transco had, over a period, achieved an average actual minus target linepack differential of between 2.6 and 2.8 mcm. Therefore Transco should be expected to achieve no more than a 2 mcm variance and should receive no reward if such differences are more than 2 mcm.

  Transco felt this was unreasonable. Such tight tolerance was unreasonable particularly given the variability of gas flows on and off the system during the last few hours of the day when Transco is severely restricted in terms of balancing actions via the Operational Guidelines.

Transco pointed out that it had not achieved such low linepack-target differences even when its sole objective (regardless of price efficiency) had been to achieve target linepack at the end of each gas day.

- The meeting considered the forms of the two incentives.

  Several shippers had concerns that the simple additive approach might give rise to Transco still enjoying reward for one component even when it has delivered "a very poor performance" in the other. Others remarked that at least such an approach kept incentives "alive" more often than the approach based upon applying the "worse of" rule to two performance factors.

  Many shippers felt that the "worse of" approach had significant merit and might ensure that Transco would, from any time, be seeking to deliver an optimum point of performance (as defined by the parameters) whereas the simple additive approach might have similar outcomes across an indifference range. Transco pointed out, however, that it was spurious to consider that Transco had sufficient certainty to be able to deduce such optimum points particularly in the light of uncertainties over gas deliveries during the last few hours of the day. Whilst the majority of shippers seemed to favour the "worse of" approach a few had concerns that such a scheme might diminish certain incentives on Transco in respect of the "dead zone" associated with the slack performance measure.

- Transco pointed out that the application of the "worse of" rules with the parameters suggested by John Williams would generate high levels of cost to Transco under this incentive if last years performance were repeated. Transco indicated that it had only been able to achieve balancing to within 2.6 – 2.8 mcm when it had solely been concerned with physical balancing. Transco pointed out that it was this concern that had provided the environment to require a price efficiency based incentive!

  Transco indicated that, with the parameters proposed by John Williams for the "worse of" incentive proposal, the base level of performance would have to be much higher than that seem in the pre-RGTA period if for the incentive to stand any chance of delivering a positive financial outcome to Transco. Any "worse of" parameter setting needed to reflect the inevitable deleterious effect on the incentive.

- The meeting discussed the principles associated with setting parameters. Transco argued that parameters could be set such that last years performance (if repeated) would yield the same outcome. Others suggested that this was far too generous and the incentive should be significantly tightened. Transco argued that the parameters proposed for the "worse of" incentive proposal were unreasonable. The effects of the application of the "worse of" rules might generate a requirement for break-even points which in performance terms represent lower attainment than might be considered politically assessment. .

  Workstream attendees suggested that the incentive scheme should be regularly reset to claw back any benefits of out-performance. Monthly resetting was suggested although the workstream suggested that provided the parameters were determined ex-ante then there should be no objection to more regular (perhaps even daily) resetting.

Transco stated it felt this conflicting with other regulatory initiatives that were designed to deliver incentives that would have effect over at least five years.

The workstream agreed that it could not recommend that a Development Report proceed to the Modification Panel next week.

The workstream agreed that it would need more time to consider these issues and hence a further meeting will be held on 20th December and it's key focus areas will be:

- Relative merits of additive term v worse of approaches
- Exploration of possible parameters/outcomes of worse of approach
- Appropriateness of regular resetting of incentive parameters.

NKS/17-Dec-00

