

Direct Dial: 020 7901 7437

18 October 2002

Shippers, Transco and Other Interested Parties

Our Ref: Net/Cod/Mod/0556

Dear Colleague,

Modification Proposal 0556 *'Amendment to Minimum Capacity Requirements for Interruptible DM Sites'*

Ofgem has carefully considered the issues raised in modification proposal 0556 *'Amendment to Minimum Capacity Requirements for Interruptible DM Sites'*. Ofgem has decided to direct Transco to implement the modification, as we believe that it will better facilitate the achievement of the relevant objectives of Transco's network code. The implementation date for the modification will be 1 October 2003.

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

Background to the proposal

Exit capacity regime

Under the current exit arrangements Transco allocates capacity on an administrative basis among Daily Metered (DM) Supply Points, Non Daily Metered (NDM) Supply Points and non-NTS Connected System Exit Points (CSEPs).

Transco currently manages network constraints predominantly by interrupting gas supply to customers with interruptible transportation agreements and by

constraining the use of LNG storage capacity that is located close to extremities of the National Transmission System (NTS).

Interruptible arrangements can also be included in contracts between shippers and their customers. Typically, such contracts provide for some level of shipper interruption and a level of Transco interruption. In terms of Transco interruption, Transco distinguishes between Standard Interruptible (SNI) and Transco Nominated Interruptible (TNI) supply points. A SNI agreement allows Transco to interrupt the site for up to 45 days each year, while Transco may interrupt a TNI site more than 45 days a year. In addition, Transco may unilaterally designate an interruptible point (either a SNI or a TNI) as a Network Sensitive Load (NSL). Such loads, by virtue of their location, are more likely to be interrupted.

In return for having interruptible status, a customer avoids various transportation charges. In particular TNI, SNI and NSL sites pay no NTS exit capacity or Local Distribution Zone (LDZ) capacity charges.

Minimum capacity requirements for interruptible DM sites

A user is registered as holding Supply Point Capacity (also referred to as Supply Point Offtake Quantity or SOQ), which is subject to a maximum and a minimum requirement. Transco sets the maximum supply point capacity as the maximum quantity that it is feasible to make available for offtake in a 24 hour period. For the purposes of the minimum supply point capacity users are required to register an SOQ that is not less than the bottom stop supply point capacity (BSSOQ) which is determined as the maximum daily consumption (or SPDQ) observed in the previous year (excluding days in the months of June to September inclusive).

Under Transco's network code, shippers are required to nominate or amend SOQ and SHQ data for a supply point taking account of historical information and future load requirements. As part of these requirements, there is an obligation to ensure that the SOQ is not greater than 24 times or less than 4 times the supply point offtake rate (SHQ), which is the maximum hourly rate at which a user is permitted to offtake gas from the system. If a supply point does not comply with this requirement, the load details of the site would be invalid preventing transfers of the supply point's ownership between users.

The BSSOQ for DM interruptible sites is revised annually as part of the collection of consumption history for the Annual Quantity review process. Following this review,

the SOQ for the site may also need to be amended to ensure that it is maintained above the revised minimum level, whilst ensuring that compliance with the SOQ/SHQ ratio is maintained. Breaches of either of these network code requirements would suggest that a revision of the SHQ and/or SOQ has not taken place. The shipper would then be required under the network code to submit a capacity revision containing the correct load figure details.

In the case of a firm DM supply point, the BSSOQ is capped at the maximum supply point capacity. At firm DM supply points, if a user offtakes more than its registered capacity, the registered capacity automatically increases (subject to a ceiling known as the provisional maximum supply point capacity). This automatic revision is not in place for interruptible sites.

In the case of interruptible sites, were shippers to comply with the rules outlined above and update their load details appropriately and in a timely manner, shipper to shipper transfers would not be hampered by the occurrence of invalid site configurations. However, there is evidence that in some instances the recorded SPDQ has been greater than 24 times the SHQ, which automatically sets a BSSOQ greater than 24 times the SHQ. Consequently shippers are placed in the position of being required to register an SOQ that is greater than the BSSOQ but in doing so will place them in breach of the SOQ/SHQ rules. Invalid load details have been repeatedly reported for a number of supply points, delaying transfers between shippers.

SO Incentives – Ofgem’s final proposals

In December 2001, Ofgem issued its final proposals on Transco’s SO incentives¹. In this document, Ofgem set out its proposed framework for the introduction of financial incentives on Transco to invest in NTS entry and exit capacity where it is efficient to do so in response to its customers’ changing needs. Ofgem also set out proposals to improve the incentives on Transco to carry out its day-to-day role of operating the NTS economically and efficiently.

On 27 September 2002, Ofgem issued a direction under section 23 of the Gas Act 1986 to modify Transco’s GT licence to implement the SO incentives and the TO price control from 1 April 2002. This direction followed two statutory licence

¹ ‘*Transco’s National Transmission System – System operator incentives 2002–7 – Final proposals*’, Ofgem, December 2001.

modification consultations on the Transco price control in April and August 2002 respectively.

As part of the SO final proposals, Ofgem set out two stages of reform for the exit capacity regime including a transitional exit capacity incentive to apply from 1 April 2002 to 31 March 2004, as well as proposals for the long term reform of the exit capacity arrangements for implementation from 1 April 2004. Both of these proposals are reflected in the licence modifications.

Under the transitional arrangements, Ofgem has proposed that Transco would offer standard interruptible contracts, as at present, with additional discounts for interruption in excess of 15 days.

In particular, with respect to the transitional arrangements, Ofgem proposed that:

- Interruptible supply points would continue to be charged on the current basis and as such would not pay NTS exit capacity charges or LDZ capacity charges. Transco will retain the rights to interrupt these supply points as defined in its network code;
- Transco would make an additional fixed payment per day of interruption with respect to interruptible sites that are interrupted on more than 15 days in any year.

Under the transitional arrangements, it is proposed that Transco would receive a target allowance for making payments in respect of interruptions of sites on more than 15 days in each year. To the extent Transco manages to beat this target it would retain a share of any difference. Conversely, if the costs of interruption in excess of 15 days exceed the target, Transco pays a proportion of the difference. Transco's incentive revenue is subject to a cap and a collar.

In addition to Transco's incentive with respect to interruptions beyond 15 days, Transco faces a similar incentive to keep the costs of interruptions up to 15 days below a target allowance. To the extent that Transco's cost of exercising interruptible rights is lower (higher) than this target, it would retain (pay) a share of any difference. The costs of interruptions are measured by the transportation charges foregone by Transco (that is, the interruptible discount that it pays to interruptible customers).

The proposal

The Transco modification proposal provides for the introduction of a cap on the minimum capacity requirement (or BSSOQ) that Transco determines for Interruptible DM Supply Points. This cap would be set at the Maximum Supply Point Capacity for the site, consistent with the arrangements applying to Firm DM Supply Points.

It is proposed that the modification be implemented from 1 October 2002.

As part of the proposal, Transco would notify the shippers of the previous winter's maximum daily consumption and the determined BSSOQ with the latter being capped at the Maximum Supply Point Capacity.

Respondents' views

A majority of respondents supported the proposal.

The respondents that supported the proposal gave different reasons for their support. Some respondents believed that the proposal would reduce difficulties with the registration process and the transfer of particular interruptible sites. Some respondents also supported the application of a consistent approach to that taken with firm DM sites. Other respondents believed that setting appropriate SOQs and the elimination of inconsistent data from Transco's database should result in more cost reflective charges to interruptible DM sites.

The respondents that did not support the proposal were concerned that the implementation of this proposal would mean that Transco and shippers would not be using the most recent information on peak load capacity for a supply point. One of the respondents said that the current methodology for the BSSOQ to be set at peak day usage for the previous year is appropriate because it is reasonable to

assume that if a customer has used this amount of gas on a given day over the past winter, it is possible for that customer to do so in the forthcoming winter. Another respondent added that if the BSSOQ is recorded as being at a particular level, in the absence of any metering error, the customer has clearly consumed the gas. The respondent stated that if the BSSOQ is recorded as being higher than a figure that would be supported by the SHQ, it is more likely that the SHQ is erroneous. The respondent therefore stated that it would be more appropriate to have a review of the SHQ in these circumstances.

These respondents also argued that since the transportation rates applicable to a number of charges on interruptible sites are derived from the BSSOQ this proposal would inflate the charges that an interruptible customer would pay above the level appropriate to their consumption.

One respondent said that the proposal was unnecessary. This respondent commented that the current rules already require users to provide correct load information. Therefore, it argued that Transco should simply identify any breach of the requirement to maintain the SOQ / SHQ ratio within the permissible range and remind users of their obligations. Ofgem should then be informed of any failure of users to respond to Transco's notification of non-compliance with network code requirements.

Transco's view

Transco stated that the proposal would remove some difficulties encountered in shipper to shipper transfers of interruptible DM sites, thus facilitating the securing of effective competition. Transco also maintained that the proposal would result in more cost reflective transportation charges by improving the quality of data and the consistency with the underlying assumptions of the LDZ charging methodology.

Transco did not anticipate significant development costs and thus concluded that the benefits of the proposal would outweigh the costs of implementation.

Transco argued that a shortcoming of the existing rules is the possibility that the safety of the system be compromised. Specifically, when a shipper has recorded a daily peak consumption higher than the maximum supply point capacity, it may interpret this recorded value as indicating that such peak flow is actually available as capacity and that it is entitled to flow at such levels in the future without

compromising the safety of the network. In this respect, Transco asserted that the uncapped BSSOQ provides misleading signals to shippers.

Transco stated that the LDZ commodity rate will increase only for those supply points with a recorded peak daily consumption higher than the maximum supply point capacity or having load details that are outside the permissible range described in the network code. Therefore, the current transportation charges would be arguably inconsistent with the charging methodology.

Transco stated that it would not ignore the most recent information available on flows and would continue to provide site consumption data to users.

Transco maintained that it is responsibility of the user to ensure that its site does not exceed the maximum supply point capacity. However, Transco stated that it is willing to assess the system impact of introducing a mechanism of notifying breaches of permissible SOQ/SHQ limits.

Ofgem's view

Ofgem has carefully considered Transco's request to introduce a limit on the minimum capacity requirement for interruptible DM Supply points in order to prevent invalid site configurations being set up for interruptible DM Supply Points.

Whilst Ofgem recognises that shippers already have requirements under Transco's network code to ensure that the SOQ/SHQ ratio is not breached, we are nevertheless satisfied that this proposal should alleviate some of the existing difficulties associated with shipper to shipper transfers for particular supply points that have invalid load details. In this respect, Ofgem considers that the proposal should better facilitate the securing of effective competition between relevant shippers and relevant suppliers.

Ofgem notes the concerns raised by a number of participants that capping the BSSOQ at the maximum supply point capacity level may effectively ignore the most recent information regarding a supply point's past gas usage. In order to respond to these concerns, Ofgem believes that Transco should discuss the mechanisms for setting the maximum supply point capacities and SHQ in more detail with industry participants in order to ensure that these parameters are determined accurately. In Ofgem's view, these discussions are also of relevance to Transco's exit capacity

incentives to the extent that the setting of the maximum supply point capacity directly impacts on the level of interruptible capacity that shippers are entitled to book and may therefore impact on Transco's risk and rewards under its incentives.

Ofgem also welcomes Transco's indication of its willingness to assess the possibility of introducing a mechanism for notifying breaches of permissible SOQ/SHQ limits. The introduction of such a mechanism may also assist in alleviating the occurrence of invalid site configurations.

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.

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,

A handwritten signature in black ink, appearing to read 'Mark Feather', is positioned above the printed name.

Mark Feather
Head of New Gas Trading Arrangements