



Shippers, Transco and Other Interested Parties

Bringing choice and value to customers

Our Ref: Net/Cod/Mod/0592
Direct Dial: 020 7901 7437
Email: mark.feather@ofgem.gov.uk

21 November 2002

Dear Colleague,

Modification Proposal 0592, 'Change to the mechanism for recovering the costs of locational balancing actions'

AEP Energy Services raised modification proposal 0592, '*Change to the mechanism for recovering the costs of locational balancing actions*' and requested that it be granted urgent status. Ofgem granted urgent status on 24 October 2002.

Ofgem has carefully considered the issues raised in this proposal and has decided not to accept it because we believe that this proposal would not better facilitate the relevant objectives of Transco's network code.

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

Background to the proposal

Transco has offered firm monthly system entry capacity (MSEC) rights to its National Transmission System (NTS) for sale via six monthly auctions since September 1999. In addition to offering MSEC, Transco also releases firm and interruptible capacity on a daily basis where there is additional capacity available. From January 2003, Transco will also release quarterly system entry capacity rights via long-term entry capacity auctions up to 15 years in advance of the time of use.

In the event of a constraint at an entry point (when physical capacity is less than capacity sold against which gas is flowing) Transco can buy back entry capacity until the constraint is relieved.

Transco has a financial incentive, known as a buy-back incentive, to minimise the costs of buying back entry capacity. The entry capacity buy-back incentive, introduced through

modifications made to Transco's Gas Transporter (GT) licence,¹ is based on a performance measure of net buy-back costs, with Transco rewarded for superior performance in relation to the performance measure and penalised for performance below the performance measure, subject to sharing factors and caps and collars.

Transco is also able to take locational gas buy and sell actions on the On-the-day Commodity Market (OCM). Transco is incentivised with respect to these actions through its residual gas balancing incentive, which is made up of both price and linepack elements. This incentive is intended to ensure that Transco balances the NTS efficiently and is contained within Transco's GT licence. The price incentive encourages Transco to take balancing actions at prices close to the system average price. The linepack incentive is intended to encourage Transco to minimise the difference between opening and closing linepack levels on a gas day.

Transco may take actions on the locational market to address a Localised Transportation Deficit (LTD), which is defined in the network code as,

'a condition affecting a part of the System resulting in a deficiency in the quantities of gas which Transco is able to make available for offtake from that part of the System whether such condition results from the size of any part of the System, the operation or failure to operate any part of the System or the extent or distribution of supply or demand in any part of the System but which does not result from a Transportation Constraint affecting a particular System Entry Point or System Entry Points.'²

Locational actions – treatment of costs

In the review of gas trading arrangements undertaken leading up to the introduction of the New Gas Trading Arrangements in 1999, Ofgas considered the appropriate treatment of purchases and sales of gas on a locational basis within the new entry capacity regime being proposed at the time.³ Ofgas anticipated that the new entry capacity regime would result in significantly lower costs associated with the buying and selling of gas on a locational basis than had previously been the case. In particular, Ofgas noted that the introduction of the entry capacity regime should significantly reduce Transco's need to sell gas at constrained terminals. In the May 1999 review of gas trading arrangements, Ofgas consulted on three alternatives for targeting the costs of locational gas. These were:

- include the costs within Transco's entry capacity incentive scheme;
- unbundle the costs of locational gas from gas balancing costs and incentivise them separately; or
- include the costs within Transco's gas balancing incentive.

Ofgas suggested that locational gas costs could be included within Transco's capacity incentive regime, as this would be consistent with a System Operator (SO) role of making capacity available and efficiently configuring the system as a whole. However, we

¹ *Transco Price Control and NTS SO incentives 2002-2007 Licence modifications*, Ofgem, September 2002.

² Section D, 1.5 of Transco's network code.

³ *Reform of Gas Trading Arrangements: Proposals and Consultation*, Ofgas, February 1999, *The new gas trading arrangements*, Ofgas, May 1999 and *The New Gas Trading Arrangements: A decision document*, Ofgem, September 1999.

considered that this approach might not be appropriate until consistent arrangements were in place at exit. We also suggested that the absence of explicit pricing for linepack makes it difficult to unbundle locational gas costs from costs associated with residual gas balancing.

In our September 1999 decision document, we accepted modification proposal 314, '*Changes to entry Capacity Entitlements Based on a SND Profile*'. This proposal provided for the introduction of a method of selling NTS entry capacity rights and provided for the creation of a Transco entry capacity incentive scheme. The proposal did not provide for the costs of locational gas to be included within the entry capacity incentive scheme. Ofgem recognised that the proposals for locational gas still required development and stated its desire to see the costs associated with locational gas included in an incentive mechanism.

In Ofgem's consideration of Transco's SO incentives for 2002-7,⁴ we stated that we did not object to Transco developing energy-based solutions to resolve capacity constraints, where this represents a cheaper alternative to buying back capacity rights. However, Ofgem stated that where Transco uses energy based tools, it should properly account for such costs and they should not influence cash-out prices under the balancing arrangements.

Ofgem would note that the buy-back performance measure within Transco's GT licence includes the following costs:

- entry capacity buy-back costs;
- any payments made by Transco to shippers in exchange for agreeing to off-take gas from the NTS at Transco's request;
- any costs incurred by Transco undertaking any other commercial or physical action to manage entry capacity.

These costs are netted off from the revenue derived from on the day sales of entry capacity, sales of interruptible capacity, non-obligated incremental capacity sales and the revenues received from overrun charges.

Events of 8 October 2002

On 8 October 2002, Transco took a number of locational actions. Responding to high and rising northern linepack levels, Transco bought back capacity at the St Fergus entry terminal to the extent of 22 mcm at a cost of over £400,000. Transco later took locational buy actions in the south-east to the extent of 3.71 mcm at a cost of over £250,000. Transco stated that linepack levels in the south were close to their minimum levels and it also suffered a key compressor failure. The costs of these locational actions were recovered through energy neutrality and the prices paid are taken into account under Transco's residual gas balancing incentive.

The proposal

AEP Energy Services Ltd has proposed that Transco pay the full cost of any Market Balancing Buy or Sell Action for the purposes of increasing or decreasing gas flows at a System Point for the purposes of avoiding or remedying a Localised Transportation Deficit (LTD). At the end of the year, Transco would add these costs to the level of costs under its buy-back incentive to determine the payment due to (or from) Transco under its incentive,

⁴ *Transco's National Transmission System Operator incentives 2002-7 Final proposals*, Ofgem, December 2001.

with all locational action costs deemed to be buy-back costs. To the extent that Transco has overpaid over the course of the year, any shortfall would be recovered through an adjustment to the SO commodity charge.

Respondents' views

There were nine responses to this proposal, including AEP Energy Services Ltd. The majority of respondents supported the proposal, while some respondents qualified their support. A small number of respondents opposed the proposal.

Transco's incentives

Those supporting the proposal considered that it would promote more efficient system operation by ensuring that Transco has appropriate incentives. They considered that it was appropriate to include locational gas actions in the buy-back incentive where Transco was buying gas to manage transportation constraints, because otherwise Transco has an incentive to use locational actions in preference to buy-back actions, irrespective of the relative costs of such actions. Some respondents stated that locational balancing actions taken at prices in excess of the NBP price are necessarily associated with transportation constraints and are therefore an alternative commercial tool to buy-backs.

One respondent which provided qualified support for the proposal argued that Transco runs an integrated system, and therefore some actions might provide multiple solutions to system operation issues on the day. It suggested that more thought was needed about the appropriate recovery of costs, including the methodology to determine which actions apply to which incentive scheme. It also argued that not every locational balancing action is associated with a transportation constraint and that Transco may be in breach of the network code by using locational actions as an alternative constraint management tool at entry.

A number of respondents considered that the current treatment of locational balancing actions may lead to inefficient system operation and one respondent considered that this might also potentially lead to inefficient levels of investment, because Transco is not fully exposed to the costs of constraints.

One respondent, opposed to the proposal, was not convinced that locational buy actions are a substitute for capacity buy-backs. This respondent suggested that selling gas on a locational basis may be a substitute for entry capacity buy-backs, or that locational actions could be considered a substitute for buying back exit capacity. This respondent considered that these issues should be considered further as part of the development of the long-term exit capacity regime.

Electricity interactions

Two respondents considered that the proposal would better align Transco and NGC's SO incentives, with one respondent arguing that the current arrangements in gas were inconsistent with NGC's SO incentives, where locational energy purchases and sales form part of NGC's incentive targets.

Governance of Transco's incentives

A number of respondents raised the issue of the governance of Transco's incentives, with one respondent considering that a licence modification may be required to include locational trades under Transco's entry capacity and exit capacity incentive schemes. Another

respondent argued that Transco's incentives had been placed in Transco's licence for stability and questioned the extent to which the incentives can be changed through changes to the network code.

The proposal for Transco to carry the costs of locational actions until the end of the year

A number of respondents questioned this part of the proposal, arguing that Transco does not pay the full costs of buy-backs and that it may discourage Transco from using the locational market.

Transco's view

Transco did not support the proposal.

Governance of Transco's incentives

Transco considered that the proposal was inconsistent with its licence and that a licence change would be required in order to implement the proposal. Transco stated that gas balancing actions taken for locational reasons need to be considered in the context of its buy-back incentive, exit incentive and the residual gas balancing incentive. It argued that the components of its buy-back incentive are specified in its licence and that the specification of the proposal to include the costs associated with Market Balancing Actions to avoid or remedy a LTD within the buy-back incentive was inconsistent with its incentive under the licence.

Transco considered that its SO incentives have been specified in its licence in order to provide it with a sufficient degree of certainty in order to allow it to respond to its incentives, as stated by Ofgem in its SO final proposals. It considered that the proposal would change its risk/reward balance.

While Transco could envisage circumstances where it might be more efficient to use gas balancing actions as an alternative to capacity buy-backs, to alleviate a constraint at entry, it stated that it had not taken this approach to date and that a change to the network code is likely to be needed to facilitate such an approach.

However, it argued that resolution of a LTD was a different matter. It did not consider a LTD as a capacity constraint, but an issue of low gas flows in some part(s) of the system, which might jeopardise security of supply unless the SO takes residual actions. Transco considered that, while the intent of the proposal may be to promote the use of entry capacity management to address LTDs, it is possible that a buy back of entry capacity rights could reduce gas flows onto the system, which might worsen the deficit at the relevant location. It suggested that, even if users re-sourced gas at another location, the time lag between buy-back action and changes in gas flows in the area associated with the LTD might mean that the deficit is not resolved in a timely manner.

Transco stated that the current treatment of LTDs has been a feature of the network code since it was first implemented and cannot be considered to have been an oversight in the context of either the licence or the network code. It stated that Transco has incentives to efficiently manage LTDs, with any Market Balancing Actions taken for such reason contributing to the price performance measure under the energy balancing incentive.

The proposal for Transco to carry the costs of locational actions until the end of the year

Transco considered that the suggested cost recovery via the SO commodity charge could lead to increased temporal misallocation of costs and considered that the current system, in which balancing costs are recovered through balancing neutrality, is likely to ensure a more appropriate temporal allocation of costs. Under balancing neutrality, the costs, which might be considered to accrue on a gas day, are recovered from users using the system on that gas day. Transco also considered that the proposal did not correctly identify the cost of the locational balancing action, because Transco recovers the costs of gas purchases through balancing neutrality.

Other issues

Transco also stated that use of locational actions to resolve LTDs is specified in its Safety Case and that, before it could contemplate alternative tools to manage LTDs, it might be necessary to submit a Safety Case change to the HSE. It argued that, if the proposal is implemented, it might not be able to exercise discretion in respect of the tools available until any Safety Case changes have been agreed.

Transco argued that the proposal does not appropriately identify the cost of the localised market balancing action, because while costs will be incurred by the purchase of gas, the gas will effectively then be sold to users under balancing neutrality. It stated that the proposal does not recognise these 'revenues'.

Ofgem's view

Transco currently has financial incentives in relation to locational balancing actions through the price element of its residual gas balancing incentive, which is contained in its GT licence. Transco's SO incentives have been specified in its GT licence to provide it with a sufficient degree of certainty in order to allow it to respond to its incentives.

Ofgem is not satisfied that including locational actions taken on the OCM within both the residual gas balancing and the entry capacity buy-back incentive would better facilitate the efficient and economic operation by the licensee of its pipeline system. In addition, Ofgem considers that Transco's incentive arrangements have been located in its licence in the interests of stability and to provide Transco with a sufficient degree of certainty. This certainty should enable Transco to efficiently respond to its incentive arrangements. In this respect Ofgem is not satisfied that making a specific change to Transco's incentives through its network code would better facilitate the efficient operation of the NTS or indeed the efficient discharge of Transco's obligations under its licence.

Notwithstanding this, Ofgem does consider that locational actions taken on the OCM to remedy a locational constraint may be a consequence of an entry capacity constraint and may be considered as a substitute for buying back entry capacity rights. In particular, the effect of constraining gas on at a particular entry point via a locational purchase on the OCM may also be achieved by buying back capacity at different entry terminals. In addition, a locational sell action at a particular terminal may be taken as a substitute for an entry capacity buy-back at that terminal.

Similar issues arise to the extent that Transco may wish to enter into capacity management contracts with market participants to 'constrain on' particular sites that are close to entry points as a substitute for buying back entry capacity rights. In this respect Ofgem notes that

payments to shippers in exchange for agreeing to off-take gas from the NTS are already covered within Transco's buy-back incentive performance measure.

As a general principle, as with constrained on contracts at particular locations, Ofgem considers that locational actions undertaken on the OCM of the nature described above should be addressed within Transco's entry capacity buy-back incentive. Nevertheless, Ofgem considers that whether such locational costs and actions are taken into account under Transco's buy-back incentive merits further consideration and discussion leading up to the review of Transco's buy-back incentive for 1 April 2004. Such a review may also need to consider the appropriate mechanism for the recovery of the costs of locational actions.

Ofgem would also note that shippers have the ability to request that the Authority directs Transco to undertake a review of its System Management Principles Statement in the event that shippers have concerns regarding the manner in which it is deploying its various system management tools under its SO incentives, including taking locational actions on the OCM.

Ofgem does not consider that the current treatment of locational trades within Transco's SO incentives is inconsistent with the arrangements applying in the electricity industry. In both industries, the SO is incentivised in relation to locational balancing trades. In the case of electricity, the appropriate treatment of NGC's constraint costs including locational trades is currently being considered in the consultation process on NGC's SO incentives for 2003/4 to 2005/6.

Ofgem's decision

For the reasons outlined above Ofgem has decided to direct Transco not to implement this modification proposal because we do not consider that it would better facilitate the efficient discharge of Transco's obligations under its licence, as contained in 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 or Lyn Camilleri on 020 7901 7431.

Yours sincerely,



Mark Feather
Head of New Gas Trading Arrangements