Direct Dial: 020 7901 7437

22 July 2002

Transco, Shippers and Other Interested Parties

Our Ref: PC74

Dear Colleague,

Pricing Consultation 74

Having considered carefully the issues raised by this consultation, and Transco's consultation report, Ofgem has decided not to veto Pricing Consultation (PC) 74, '*Interruptible Transportation Charges*.' The reasons for this decision are set out in the accompanying paper.

This proposal introduces, in addition to the present interruptible exemptions from the relevant National Transmission System (NTS) exit capacity and Local Distribution Zone (LDZ) capacity charges, a transportation credit payable when individual supply points are interrupted for more than 15 days in a year.

The transportation credit that is payable for each additional day of interruption over 15 days will be equivalent to one fifteenth of the annual NTS exit capacity and LDZ capacity charges avoided as a result of the interrupted supply point having interruptible rather than firm transportation rights. Under the proposal Transco's existing right to interrupt a supply point for up to 45 days a year, or more for Transco Nominated Interruptible (TNI) supply points, would not be changed.

As part of the proposal, the present commodity discount applicable in respect of TNI supply points will be discontinued.

This change to the charging methodology will take effect from 1 October 2002.

If you have any questions on this letter, or the accompanying paper, please contact me on the number above.

Yours sincerely,

Mark Feather

Head of New Gas Trading Arrangements

Ofgem's views on Transco's Proposal for Interruptible Transportation Charges (PC74)

Background

The existing exit capacity, interruption and LNG arrangements

Under the existing exit capacity, interruption and LNG arrangements, Transco manages network constraints mainly 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 NTS. Transco may call interruption in the event of network capacity constraints, high system demand, in an emergency or for testing purposes.

Interruptible transportation arrangements can be included in contracts between shippers and their customers. Typically, such contracts provide both for some level of shipper initiated interruption as well as Transco initiated interruption. At present, any supply point that has daily metering and annual consumption in excess of 5.86 GWh can apply for interruptible status.

In terms of Transco interruptions, 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 in each year, while a customer with a TNI agreement may face greater than 45 days of interruption. 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 receives relief from various charges. A SNI site pays no NTS exit capacity or LDZ capacity charges. In addition to this, a TNI site receives a reduction in NTS commodity charges. However, no additional compensation is provided to an NSL.

SO incentives – Ofgem's final proposals

Ofgem published its final proposals for Transco's NTS System Operator (SO) incentives for 2002-7 in December 2001[1] and published licence modifications for statutory consultation under section 23 of the Gas Act 1986 together with an

[1] *'Transco's National Transmission System Operator Incentives – Final proposals'*, Ofgem, December 2001.

explanatory note on 12 April 2002.[2] These proposed modifications seek to introduce into Transco's Gas Transporter (GT) licence, with effect from 1 April 2002, new price controls and system operator (SO) incentives. Ofgem is currently considering the responses that it has received to this consultation. The views expressed in this letter do not in anyway fetter the discretion of the Authority with respect to the proposed licence modifications referred to above.

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 these proposals are contained in the legal drafting of the modification and are explained in Ofgem's explanatory note that accompanied the section 23 notice that was issued on 12 April 2002.

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.

Ofgem also suggested that in the transitional arrangements, Transco should keep its existing rights to interrupt SNI supply points on up to 45 days a year, or on more than 45 days for TNI supply points.

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

[2] *'Transco price control and NTS SO incentives 2002-7 Proposed licence modifications'*, Ofgem, April 2002.

would retain a share of any difference. Conversely, under the proposals if the costs of interruption of in excess of 15 days exceed the target, Transco pays a proportion of the difference.

Transco's pricing consultation proposal

Transco has proposed that, in addition to the present exemption from the relevant NTS exit capacity and LDZ capacity charges, a transportation charge credit be payable when individual supply points are interrupted on more than 15 days in a year. This transportation charge credit would:

- be equivalent to one fifteenth of the annual NTS exit capacity and LDZ capacity charges avoided as a result of the interrupted supply point having interruptible rather than firm transportation rights; and

- be paid by Transco for each additional day of interruption over 15 days.

Under this proposal, Transco would retain its existing rights to interrupt SNI supply points for up to 45 days a year. It will also retain its right to interrupt TNI supply points for more than 45 days a year.

Finally, it is proposed to discontinue the present commodity discount applicable in respect of transportation to TNI supply points.

The proposed change in the charging methodology would be introduced from 1 October 2002.

Respondents' views

Introduction of a transportation charge credit

A number of respondents were concerned that the proposal would encourage Transco to minimise the cost of interruption by choosing to interrupt a site based on cost rather than on the basis of the interruptible algorithm and the fair and equitable treatment of all supply points. These respondents were of the opinion that Transco would be more likely to interrupt larger supply points and that whether the site was connected to the NTS and LDZ might affect the choice of sites to interrupt. In this respect, some respondents raised concerns that Transco would be discriminating between sites. They also noted that such discrimination is not present in the current system of selection based on interruptible algorithms.

Some respondents stated that Transco would need to develop a new methodology to determine which sites to interrupt and wanted Transco to consult on this methodology. One respondent was concerned that the formula used to establish the credit rebate does not attempt to reflect the different commercial costs incurred by different supply points associated with being interruptible. This respondent indicated that PC74 does not give customers the right to choose the level of service they want at a price they are happy with.

Two respondents commented that under the proposals some sites could receive negative transportation charges as the rebate for interruption could be greater than the full transportation charges that they would otherwise incur. One respondent queried whether this would be cost reflective.

Some respondents raised concerns as to whether the credits that are paid with respect to interruptible sites will be passed through to the end user by the shipper.

Several respondents offered their support for the proposal, with some qualifying this support on the basis of the concerns outlined above. One respondent stated that the one-fifteenth transportation charge credit for each day of interruption above 15 days represents a fair and cost reflective price.

Removal of the commodity discount for TNI supply points

The majority of respondents that commented on the TNI discount did not support its removal. Several respondents noted that the TNI discount compensates for the extra risk management costs faced by TNI supply points including standby fuel costs. These costs are incurred whether or not the sites are interrupted on more than 15 days. In general, respondents were concerned that, under the proposed transportation charge credit arrangements , TNI sites would not be adequately compensated for their service.

One respondent believed that the removal of the TNI discount might encourage Transco to change SNI supply points to TNI supply points. Another respondent suggested that the existing discount should be used until the credits allocated to a site for interruption above 15 days exceed the site's commodity discount.

A number of respondents supported the proposal. Two of them believed that the rebate in the event of interruption on more than 15 days was more than sufficient.

Implementation

Several respondents noted that for the proposal to work in practice changes to Transco's Network Code and billing would be required. They expressed concern about the feasibility of implementing the necessary changes for implementation on 1 October 2002. For these reasons, another respondent suggested that the proposal be implemented not earlier than 1 April 2003.

Some respondents raised questions regarding the payment of credits. Specifically, they queried when credits would be paid to shippers and how they would be made where a shipper nominated an alternative site for interruption to that initially proposed by Transco. A number of respondents also queried how shared supply meter points and sites with partial interruption are to be treated under the proposed arrangements.

Other issues

Some respondents referred to the proposed amendments to Transco's GT licence and Ofgem's SO incentives proposals. One respondent indicated that changes should not be made until the final version of Transco's licence is known following the outcome of the licence consultation. The respondent commented that it was difficult to judge the proposal against the licence proposals which have not been finalised and that therefore the proposal should be subject to further discussion and consultation.

Some respondents did not support this proposal because they believed that the industry should be focussing on the long-term arrangements and not on the transitional arrangements for exit capacity.

A number of respondents indicated that they would like Transco to provide a wider range of options for interruptible services to suit the individual requirements of customers.

One respondent suggested that end users should be able to signal their willingness to strike interruptible contracts above 15 days and that without such an ability it will not be possible to gauge the viability of moving to longer term arrangements.

Transco's view

Transco considers that the proposal is in line with Ofgem's proposed licence requirements and believes that the proposal complies with the conditions set out in the proposed licence modifications with regard to the SO exit incentive.

Introduction of a transportation charge credit

Transco stated that the basis for selecting a site for interruption purposes is set out in the Operational Guidelines and that it does not intend, at present, to change the basis of the selection of proposed sites for interruption to take into account the level of interruptible rebates. Transco maintained that the selection basis in the Operational Guidelines tends to result in an even selection of sites within an area, subject to local constraints.

Transco notes that in recent years, the sites most likely to be interrupted have been NSLs. Since the requirement for interruption is constrained to the area of the NSL, Transco has little discretion in selecting alternative sites. Therefore, the impact of the proposed exit arrangements is more likely to be an incentive on Transco to reduce the need for interruption in these areas by increasing, for example, the level of available capacity.

Removal of the commodity discount for TNI supply points

Transco stated that the proposed structure of capacity charges foregone and additional credits is likely to reflect the costs borne by TNI sites more effectively than the present fixed discount structure.

Implementation

Transco noted that the implementation of the proposed changes was discussed at the Capacity Workstream and that Network Code Modification Proposal 0555, *'Interruptible Transportation Charges'* was raised by Transco to amend the Network Code to assist in enabling their implementation. Transco believed that this modification proposal can be progressed in time for implementation from 1 October 2002. Transco also stated that it has identified the changes to billing systems and formats and considered that it should be possible to implement the changes before the first credit payments are likely to be made since it is unlikely that any sites would be nominated for interruption beyond 15 days before January 2003.

Transco explained that under Modification Proposal 0555 credits would be paid to shippers for interruptions in excess of 15 days on a monthly basis and such credits would relate to the site initially proposed by Transco rather than any alternative nominated by the shipper. Transco added that the arrangements between shippers and end users as regards the credits would be subject to normal commercial considerations.

Transco agreed with those shippers who claimed that credits, in some circumstances, could be higher than transportation charges.

Other issues

Transco suggested that the comments of respondents on other types of interruptible services should be discussed in the context of the post-transitional regime. It noted that the proposed changes relate to interruptible arrangements in the transitional period, from April 2002 to March 2004 or whenever universal firm registration is put in place.

Ofgem's view

Ofgem notes that Transco considers that this proposal is in line with Ofgem's proposed licence requirements and that Transco believes the proposal complies with the conditions set out in the proposed Licence modifications with regard to the SO exit capacity incentive arrangements. On this basis, Transco considers that the implementation of the proposal is consistent with the objectives set out in amended standard condition 4 of its GT licence.

Ofgem would however reiterate at the outset that the licence modification proposals that provide for the introduction of the exit capacity incentive arrangements and which are set out in the section 23 notice that was issued on 12 April 2002 have not been implemented and that Ofgem is currently considering the responses it has received to the section 23 consultation. As such, it is not possible for Ofgem to approve this proposal on the basis that it is in line with Ofgem's proposed modifications to Transco's GT licence. In this respect we would note that this proposal has to be assessed against the background of the licence as it exists today, not as it may be in the future as a result of a proposed licence modification.

Notwithstanding this, Ofgem supports the proposal on the basis that the transportation credits payable under the proposals better reflect the value to Transco of the costs saved and the services provided by interruptible sites that are interrupted in excess of 15 days. In this respect Ofgem considers that the proposal represents a move towards more cost reflective charging for interruption.

The proposals also go some way towards addressing the potentially discriminatory treatment of different types of interruptible customers. Ofgem's concerns regarding the discriminatory nature of the interruptible exit arrangements were outlined in Ofgem's March Exit Capacity, Interruptions and LNG document[3] and Ofgem's SO Incentives Initial Proposals document of September 2001[4]. In these documents, Ofgem expressed concerns that the existing arrangements may discriminate between interruptible users by granting similar discounts to sites that provide different levels of interruptible service. In this respect, customers who are not on standard terms of interruption have expressed concerns that they face a higher probability of interruption and are not adequately compensated for their services.

On this basis, having regard to Transco's licence as it exists today and not how it may be amended in the future and it statutory duties and all relevant facts, Ofgem considers that the proposal is consistent with the relevant objectives set out in amended standard condition 4A of Transco's GT Licence.

Ofgem recognises the concerns that have been raised by some respondents regarding the basis on which Transco may choose to select different sites for interruption. Ofgem would however draw respondents' and Transco's attention to section 9 of the Gas Act 1986, in particular, sub paragraph 9(1A) which specifies that it shall also be the duty of a gas transporter to facilitate competition in the supply of gas and subparagraph 9(2) to avoid any undue preference or undue discrimination in the operation of the pipe-line system or on the terms on which it undertakes the conveyance of gas. Further, amended standard condition 4D of its GT licence specifies that Transco must conduct its transportation business in a manner best calculated to secure (among other things) that a gas shipper does not obtain any unfair commercial advantage from a preferential or discriminatory arrangement.

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[3] *The new gas trading arrangements: review of Transco's exit capacity, interruption and liquefied natural gas arrangements,* A consultation document, Ofgem, March 2001
[4] *Transco's National Transmission System – System Operator Incentives 2002-7*, Initial Proposals, Ofgem, September 2001.

Removal of the commodity discount for TNI supply points

In our April 2002 explanatory note to the proposed Transco GT licence modification, we noted that, under the existing arrangements, TNI sites are entitled to additional reductions on NTS and LDZ commodity charges. These reductions reflect the benefits to Transco of having sites that can be interrupted for more than 45 days per year. We commented that if Transco implements a new charging regime for compensating sites that are interrupted for more than 15 days a year it would be paying additional compensation to all sites which are frequently interrupted. Ofgem indicated that it would be up to Transco to consider whether the current special discounts for TNI sites are still appropriate and to address this issue through a pricing consultation process.

Ofgem believes that in circumstances where Transco intends to make additional payments with respect to sites that are interrupted for more than 15 days a year there is no longer a need for additional compensation to be paid in the form of the commodity discount to TNI customers.