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28 July 2004

Dear Colleague,

Transco Pricing Consultation PC81 - Interruptible Transportation Charging

Transco raised Pricing Consultation (PC) 81 *'Interruptible Transportation Charging'* in May 2004 and published its PC81 report on 30 June 2004. Ofgem has carefully considered the views of the respondents to this pricing consultation. Ofgem has decided to veto this proposal because it does not better facilitate the relevant objectives of Transco's charging methodology, as set out in amended standard condition 4A of Transco's Gas Transporters (GT) licence.

In making this decision, Ofgem had regard to Transco's obligations under its GT licence and Ofgem's wider statutory duties.

The background to this decision is set out in the appendix to this letter. The reasons for the decision are set out below.

Where demands on the gas transportation system exceed available capacity, Transco can use a range of tools, including the interruption of designated interruptible sites, to maintain system security to firm customers.

Transco's NTS System Operator (SO) incentives for 2002-2007 set out two stages of reform for the exit capacity regime including a transitional exit capacity incentive to apply until April 2004 and proposals for the long-term reform of the exit capacity arrangements to apply thereafter.

The licence conditions introduced transitional exit arrangements under which Transco would be required to make additional payments to shippers with respect to NTS and LDZ supply points interrupted for more than 15 days. Ofgem considered that the obligation to pay for additional interruption would provide an incentive to Transco to contract for the level of interruption it required through market based mechanisms. Ofgem considered that the market based arrangements would allow shippers to be efficiently compensated for the level of interruption that they were providing. The arrangements would also provide signals of the value of interruption on the network and would allow Transco to make efficient trade offs between the system management services and network investment.

Transco's proposal

Transco raised PC81 in May 2004. PC 81 proposed to modify the circumstances in which shippers to interruptible supply points would become eligible to receive credits arising from interruption beyond 15 days within a formula year (1st April to 31st March). Transco proposed to exclude interruption arising solely for the purposes of supply and demand gas balancing from the count of qualifying interruptible days.

For the avoidance of doubt, Transco would continue to have the right to interrupt for supply and demand purposes as part of the right to interrupt interruptible supply points up to 45 days, and more in the case of Transco Nominated Interruptible (TNI). However, interruption for supply and demand purposes would not count towards the 15 day allowance for the purposes of the 1/15th credit. Therefore, no credit would be paid to shippers by Transco for interruption relating to supply and demand balancing.

Transco suggested that this proposal would provide incentives to shippers to effectively contract for commercial interruption thereby promoting the effective balancing of shippers' portfolios at a time of tightening supply and demand.

Respondents' views

There were ten responses to PC81. Two respondents expressed support for the proposal. A further two respondents offered qualified support. The remaining six respondents were against the proposal. A further six of the respondents agreed with the principle of removing the 1/15th credit for supply and demand balancing from the exit capacity investment incentive arrangements, however, four of these did not believe that this proposal was the appropriate vehicle to implement this.

The common objection to PC81 from the six respondents who were against the proposal was that removing the credit could perversely create an incentive for Transco to call all interruption for supply and demand purposes, rather than for other transportation constraints and rather than effectively utilising the OCM, since it would be a free option.

The two respondents, who offered qualified support, did so on the basis of further developments being necessary to prevent the possible negative impact that could arise from the proposal. One respondent was concerned that Transco may not utilise the OCM fully to alleviate any constraints before resorting to interruption. The second respondent agreed with the removal of this credit from the incentive mechanism but only if a second proposal was implemented concurrently introducing a payment from Transco for supply and demand interruption.

One of the respondents who expressed support for the proposal suggested revising the implementation date to April 2005. It suggested that this proposal could affect existing commercial arrangements, and delaying implementation would allow customers to factor this proposal into their gas purchasing decisions.

Transco's response

Transco stated that it has attempted to reassure concerned parties in open forum that in principle Transco would utilise the OCM to its full extent in preference to supply and demand interruption until such point that it felt that there were no more actions that would provide an appropriate physical response in an acceptable time period. Transco stated that it intends to propose an amendment to the System Management Principles Statement (SMPS)[1] to provide further assurance of this approach.

With respect to the timing of implementation, Transco stated that this proposal was set out in the context of a tightening supply and demand position in this coming winter. Transco further commented that discussion with industry regarding this proposal has been underway since April 2004.

Ofgem's views

Given the intentions behind the exit capacity incentive arrangements Ofgem does not consider that PC 81 should be implemented. There are a number of interactions within Transco's SO incentive arrangements which would need to be given further consideration in conjunction with Transco's charging proposal under PC 81. Therefore, PC81 would not necessarily facilitate the achievement of Transco's relevant methodology objectives. It would not result in a change to the methodology which allowed Transco to better reflect the costs of interruption, which was one of the intentions behind the 15 day credit provisions, nor would it necessarily result in the separation of supply and demand interruptions from constraint related interruptions.

Ofgem agrees with the principle of promoting more efficient arrangements for gas balancing through shipper led commercial interruption contracts. Gas balancing and transportation interruption should be separated to reflect the costs that Transco incurs in separately managing its residual gas balancing and transportation capacity management role. Ofgem is concerned that the existing Transco interruption arrangements potentially distort the efficiency of the gas balancing regime. This is because the costs of interruption for gas balancing purposes under existing Transco contracts are not reflected in gas cash-out prices. Nevertheless, it is not clear that changes proposed as part of PC81 would deal with these difficulties.

While Ofgem notes Transco's assurance that it would utilise the OCM to its full extent to manage its residual gas balancing role, under PC 81 Transco would have a free option to interrupt customers under the existing administered interruption contracts as opposed to using market based arrangements to balance the system.

Ofgem considers that Transco's proposals could be better addressed as part of the overall framework of Ofgem's current review of the Cash-out and Top-up arrangements.

As a result of vetoing this proposal, the current arrangements for Transco crediting shippers for interruption over 15 days will remain in place.

If you have any further questions on this letter please do not hesitate to contact me on the above number or Matthew Young (tel 020 7901 7266).

Yours sincerely

AJ Walker

Andrew Walker
Director – Transmission Networks Regulation

[1] System Management Principles Statement (SMPS) – Transco is required to establish a SMPS in accordance with Special Condition 27 of its Gas Transporters licence. The purpose of this Statement is to describe the basis on which Transco will employ system management services. This Statement is ultimately constrained by the obligation on Transco to operate the system in an efficient, economic and co-ordinated manner.

Transco's pricing consultation proposal for Interruptible Transportation Charging (PC 81)

Background Information to PC 81

Gas balancing arrangements are currently divided into primary balancing obligations, placed upon shippers and residual gas balancing obligations, borne by Transco and set out under the network code. The gas balancing regime provides shippers with incentives to balance demand and supply at the end of the gas day through the cash out mechanism. The current SO arrangements incentivise Transco as residual gas balancer to reduce the costs incurred as a result of balancing the pipeline system. Transco undertakes this task using a range of physical and financial tools, including its use of interruption and linepack.

The cash out regime

Shippers who are long (short) on gas are cashed out at the lowest (highest) prices at which Transco has sold (bought) gas on the on-the-day commodity market (OCM)[2]. These cash out prices are the system marginal sell price (SMP sell) and the system marginal buy (SMP buy) price respectively. In the event that Transco has not taken any balancing actions, cash out prices are determined using fixed differentials that are added to the system average price (SAP) which is the weighted average price of gas traded on the OCM. The fixed differentials are based on the cost of storage.

Shippers have commercial incentives under the network code to balance their inputs and offtakes of gas to the system each day. Transco undertakes the role of residual system balancer to the extent that shippers do not balance their inputs and offtakes and the system becomes long or short in aggregate over the gas day. As residual system balancer Transco buys and sells gas on the OCM to ensure that the National Transmission System (NTS) remains in balance and that linepack remains within safe operational limits. When linepack is falling (i.e. offtakes exceed inputs) Transco may buy gas. Conversely, when system inputs exceed offtakes Transco may sell gas to bring the system back into balance.

Exit and interruption arrangements

Transco currently manages network constraints under the existing exit capacity, interruption and liquefied natural gas (LNG) arrangements mainly by interrupting gas supply to customers with interruptible transportation agreements. 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 interruption (commercial interruption) as well as Transco 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. An SNI agreement allows Transco to interrupt the site for up to 45 days each year, while a customer with a TNI agreement may face greater than 45 days of interruption. In addition, Transco may unilaterally designate an

[2] The on-the-day commodity market is an electronic trading system where shippers and Transco may post and accept offers and bids to effect market transactions. The system buy and sell actions taken by Transco to alleviate a locational constraint on the NTS are not included in cash out prices.

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 capacity charges. SNI and TNI sites pay no National Transmission System (NTS) exit capacity or Local Distribution Zone (LDZ) capacity charges. No additional compensation is provided to an NSL.

Transco's residual balancing incentive

Transco's gas balancing incentive has two components.

- The price component provides Transco with a daily financial incentive to buy and sell gas at prices close to the average market price. Transco earns revenue if it minimises the spread between its marginal buy price and marginal sell price or if it takes no actions. Transco is exposed to a penalty when the differential between the marginal buy or sell price exceeds 20 percent of system average price (SAP).

- The linepack incentive is designed to discourage Transco from carrying over imbalances from day to day as this would lead to less accurate cost targeting under the regime. Companies that were out of balance at the end of the day might not face the costs associated with Transco's actions.

PC 74

In July 2002, Ofgem approved pricing consultation 74, *'Interruptible Transportation Charge's*, (PC 74). PC 74 proposed that, in addition to the existing interruptible exemptions from the relevant NTS exit capacity and LDZ capacity charges, a transportation credit would be paid when individual supply points are interrupted for more than 15 days in a year.

Modification proposal 0555 'Interruptible Transportation Charges'

In October 2002, Ofgem accepted modification proposal 0555 *'Interruptible Transportation Charges'* which introduced a reduction in the level of transportation charges in respect of supply points that Transco interrupts on more than 15 days in a year (measured from April to March). Under the modification, for each day of nominated interruption over 15 days, a transportation charge credit would be available, equivalent to 1/15 of the annual NTS exit capacity charge and LDZ capacity charges avoided as a result of the interrupted supply point having interruptible rather than firm transportation rights. Transco's existing right to interrupt a supply point for up to 45 days a year, or more for TNI supply points, was unchanged.