

Draft Modification Report
Change to the cash-out arrangements where Transco defines Operating Margins (OM) gas
usage for end of day balancing purposes
Modification Reference Number 0607
Version 1.0

This Draft Modification Report is made pursuant to Rule 7.3 of the Modification Rules and follows the format required under Rule 8.9.3.

1. The Modification Proposal

This Modification Proposal (and the related Modification Proposal 0606) has been raised following discussions in Workstream meetings and the development of Business Rules for Modification Proposal 0575: "Revisions to cash out pricing and the methodology for recovery of OM costs".

The Proposal states:

"The two modifications represent two distinct approaches, arising from the Modification Proposal 0575 development process. Modification Proposal 0575 proposed that Transco use the full costs of any OM gas utilisation (reflecting storage space, gas, injection and withdrawal costs) to derive a unit cost that might feed into the cash out price determination process where Transco has used OM gas for end of day balancing purposes. Following Workstream discussions, it was agreed that the development process had led to two different approaches that were sufficiently different from the original proposal to merit consideration as two separate Modification Proposals. Detailed business rules have been produced by the Workstream as part of the Modification Proposal 0575 development process for each alternative proposal.

Under the current Code rules and transportation charging methodology, OM storage capacity costs are recovered through the SO commodity charge. All other OM costs are recovered either via the Daily Margins Recovery Amount used in the determination of Balancing Neutrality Charges or via the Closing Margins Adjustment Charge. As a result, all OM costs are recovered from the whole market with no targeting of the costs to different users who cause them to be incurred.

Such a treatment of the costs would be reasonable and cost-reflective if all OM holdings and all use of OM were for "system" purposes to the benefit of all system users equally. In Transco's OM report, published each year, Transco states that it holds OM against the following events:

- i. beach supply failure;
- ii. late within day change in forecast demand;
- iii. NTS compressor failure; and
- iv. NTS pipeline failure.

Costs associated with using OM gas for the first two categories should be targeted to the users who cause them to be incurred. Where OM's are used for end of day balancing purposes, the

costs should be used in determining cash-out prices.

Recovering costs from all users may lead to a significant cross-subsidy between shippers who are in balance (or long) and those shippers who are short on peak days. The current arrangements also send inappropriate price signals of the risk and costs imposed on the system by shippers who are short on peak days. The current arrangements could also artificially dampen imbalance prices on peak days where OM gas is used to correct an end of day imbalance.

This proposal could, compared with the existing rules, lead to significantly higher cash out prices on days where OM gas is used for end of day balancing purposes. The proposal would not, however, place any restriction or cap on cash out prices. Where Transco took other balancing actions in addition to OM usage at higher prices, these higher priced market actions would still be used to determine cash out prices."

Transco would calculate an OM unit cost (in p/kWh) and publish these costs in accordance with rules set out in the Network Code. When OM gas was used, Transco would determine at the time whether the OM gas was used for system balancing (i.e. within day balancing and/or NTS constraints/compressor failure) or end of day balancing purposes. Where Transco determined that OM gas was used for end of day balancing purposes, the OM unit cost would be included in the calculation of SMP cash out prices as if it had been an action taken on the OCM. If the OM unit cost was above the highest priced balancing action taken by Transco for that day, the OM unit rate would be used in the determination of the System Marginal Buy Price (via revision of F 1.2.1 (i) (b)). Similarly if the OM unit cost was the lowest priced balancing action taken by Transco for that day then it would be used in the determination of the System Marginal Sell Price (via revision to F 1.2.1 (ii) (b)) This Proposal does not advocate amending the basis for the calculation for the System Average Price. If the OM unit cost was below the highest prices balancing action taken by Transco for that Day, the System Marginal Buy Price would be the highest priced action on the OCM."

The detailed business rules developed as part of the Modification Proposal 0575 development process and subsequent discussion of this Proposal are attached to this Draft Modification Report.

2. Transco's Opinion

Transco notes that the intention of the Modification Proposal would be to increase the incentive on Users to balance. The Proposal advocates that this would be achieved by defining a mechanism whereby a cost and value related unit price for potential OM utilisation is derived and this price would contribute to the determination of the daily SMP Buy price when OM is used for end of day balancing. Transco would have discretion for defining if OM had been used for end-of-day balancing purposes.

The Proposal defines a methodology for determining a unit cost associated with OM gas utilisation. This unit cost would be SAP plus an increment, the increment reflecting an average cost of the non-gas elements of OM (based on an assumption that the OM gas requirement will be used). The Proposal defines that the treatment of the price associated with OM utilisation for end-of-day balancing purposes would be analogous to that associated with the price of any other Market Balancing Action used for the purposes of determining the SMP Buy price. The Proposal could lead to stronger incentives to balance on days of OM usage but these events are very rare.

There have been no incidents of OM usage over the last three winter periods that have been categorised as being for end-of-day balancing purposes. Transco notes that the NT&T Workstream accepted the principle that the existing control room processes would be used to define whether any OM usage is taken for end-of-day balancing purposes.

Transco considers that implementation of this Proposal may strengthen Users' incentives to balance in a manner that is consistent with sending cost reflective signals. Transco therefore considers that implementation of this Proposal might generate an appropriate incentive for Users to avoid short positions on days when OM might be used for end of day purposes. Transco therefore concludes that implementation of this Proposal would provide stronger, but appropriate, incentives on Users to ensure their supply/demand matching and that this would better facilitate the economic and efficient operation of the System by reducing the uncertainty and extent of Transco's residual system balancing role.

3. Extent to which the proposed modification would better facilitate the relevant objectives

The Proposer states that this Proposal would better facilitate the relevant objectives of the efficient discharge by Transco of its obligations under its Licence in respect of the economic and efficient operation of the pipeline system. The Proposer also indicates that it is envisaged that it would facilitate competition between Shippers and Suppliers by reducing the potential for cross subsidies. By improving cost reflectivity, particularly on peak days, the Proposal would better facilitate the objective of providing reasonable economic incentives for relevant suppliers to secure that the domestic customer supply security standards (within the meaning of paragraph 4 of Standard Condition 32A (Security of Supply " Domestic Customers) of the standard conditions of Gas Suppliers" licences) are satisfied as respects the availability of gas to their domestic customers.

4. The implications for Transco of implementing the Modification Proposal , including a) implications for the operation of the System:

Increasing the incentive on Users to attain an end-of-day balance might lead to reduced within-day mismatches between NTS input and offtake flow rates, which in turn might lead to reduced flow and linepack variation to the benefit of the economic and efficient operation of the System.

b) development and capital cost and operating cost implications:

Changes to Transco's existing systems would be required to part-automate the revised cash-out price derivation process. Transco's provisional estimates suggest that development and implementation costs would be in the order of £100k. Additionally, modest operating costs might result from the requirement to derive and publish the assessment of the non-gas cost contribution to the OM price.

c) extent to which it is appropriate for Transco to recover the costs, and proposal for the most appropriate way for Transco to recover the costs:

Any additional System Operator costs would be shared with Users as defined within the internal cost incentive scheme defined in the GT licence.

d) analysis of the consequences (if any) this proposal would have on price regulation:

The proposal is not considered to have any consequences in respect of price regulation.

5. The consequence of implementing the Modification Proposal on the level of contractual risk to Transco under the Network Code as modified by the Modification Proposal

No such consequences are anticipated.

6. The development implications and other implications for computer systems of Transco and related computer systems of Users

Transco has estimated that implementation of the Proposal would lead to system development and implementation costs in the order of £100k. Transco would welcome views on the implications for Users' computer systems.

7. The implications of implementing the Modification Proposal for Users

Implementation of this Proposal might result in a changed level of risk to Users due to the potential increased exposure to cash-out prices at peak demand levels.

8. The implications of implementing the Modification Proposal for Terminal Operators, Consumers, Connected System Operators, Suppliers, producers and, any Non-Network Code Party

Transco does not believe that there would be a direct effect on the above parties.

9. Consequences on the legislative and regulatory obligations and contractual relationships of Transco and each User and Non-Network Code Party of implementing the Modification Proposal

No changes to contractual relationships are anticipated.

10. Analysis of any advantages or disadvantages of implementation of the Modification Proposal

Advantages

- The price of OM gas might influence cash-out price determination.
- Users' incentive to balance might be increased.

Disadvantages

- Increased uncertainty regarding cash-out prices (no longer solely based on the EnMO provided Traded System.)

11. Summary of the Representations (to the extent that the import of those representations are not reflected elsewhere in the Modification Report)

Representations are now invited.

12. The extent to which the implementation is required to enable Transco to facilitate compliance with safety or other legislation

Transco does not believe that implementation of this Modification Proposal would affect compliance with safety or other legislation.

13. The extent to which the implementation is required having regard to any proposed change in the methodology established under Standard Condition 4(5) or the statement furnished by Transco under Standard Condition 4(1) of the Licence

Not applicable

14. Programme of works required as a consequence of implementing the Modification Proposal

A programme of works would need to be developed should the Modification Proposal be implemented.

15. Proposed implementation timetable (including timetable for any necessary information systems changes)

16. Recommendation concerning the implementation of the Modification Proposal

Transco recommends implementation of the Modification Proposal.

17. Text

Representations are now sought in respect of this Draft Report and prior to Transco finalising the Report

Signed for and on behalf of Transco.

Signature:

Tim Davis
Head of Regulation NT&T

Date: