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Dear Colleague,

Network Code Modification Proposal 0618 "Publication of shrinkage provider gas procurement and disposal information"

Ofgem has carefully considered the issues raised in network code modification proposal 0618 *"Publication of shrinkage provider gas procurement and disposal information"*. Ofgem has decided to direct Transco not to implement modification proposal 0618 because it believes that the proposal would not better facilitate the relevant objectives of Transco's network code under standard condition 9 of Transco's Gas Transporter (GT) licence.

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

Background to the proposals

Shrinkage Gas

Shrinkage gas is gas lost through the transportation system at both the LDZ and NTS level. LDZ gas shrinkage includes gas lost through leakage, theft and gas used for operational purposes. NTS shrinkage gas includes own use gas[1], unaccounted for gas[2] and unbilled energy[3].

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[1] Own use gas includes gas used for compression, venting and preheating.
[2] Unaccounted for gas arises from meter inaccuracies and discrepancies between measured flows and actual physical flows leading to differences in measured NTS entry and exit volumes.
[3] Unbilled energy is the result of differences between the actual calorific value of gas delivered onto the NTS and the average (flow weighted) calorific value upon which billing is based.

Transco recovers the costs associated with NTS shrinkage gas through the system operator (SO) commodity charge whilst LDZ shrinkage gas is recovered as part of general transportation revenue.

The costs of NTS shrinkage can be influenced by Transco's actions as NTS SO. As such, Transco has been provided with financial incentives under its GT licence to manage shrinkage gas costs efficiently. Under this incentive scheme for the period 1 April 2002 to 31 March 2007, Transco receives a fixed allowance for gas shrinkage costs.

Under these arrangements, the target cost levels have been set at £59.5m for 2002/3 and £59.7m for 2003/4. The target was set using Transco's forecast of the volumes of required shrinkage gas. These forecast volumes were then multiplied by a price of gas derived using current forward prices for national balancing point (NBP) gas to derive a target. A premium was added to the forward prices to take account of short-term uncertainties faced by Transco in procuring shrinkage gas.

Transco also faces target gas volumes for the final three years of the price control (from 1 April 2004 to 31 March 2007). During this three year period Transco's cost target is set by multiplying these volumes by an NTS SO gas cost reference price that is determined using a formula set out in Transco's GT licence to take account of future forward prices.

Under the present incentive, if Transco performs better (worse) than the target it bears 25 (20) percent of the difference. A cap of £4million and a collar of -£3million limit Transco's exposure under this incentive. Any balance is borne by shippers through the SO commodity charge. The sharing factors and caps and collars have been set for 2 years and are currently being reviewed for the period commencing 1 April 2004.

Gas procured for shrinkage purposes is accounted for separately under Transco's shrinkage provider (SP) account. Under the network code, the shrinkage provider is treated as a User. However, it is currently not required to hold system capacity rights or to pay for capacity and commodity charges.

In 1995, Transco entered into a long term bilateral contract with British Gas Trading to purchase shrinkage gas "at the beach". This contract is due to expire in September 2005. From 1 October 2002, Transco has put in place additional arrangements with other counterparties to meet its shrinkage gas requirements.

Modification proposal 0599 *"Obligation on shrinkage provider to purchase gas at the NBP"* was approved by Ofgem on 29 August 2003. It provides that all shrinkage gas be procured by Transco at the NBP from 1 April 2004. In approving it, Ofgem stated that the modification would have aligned Transco's shrinkage gas procurement activity with its NTS SO gas cost incentive, thus strengthening Transco's incentive to improve the efficient operation of its system. As a consequence of this modification, Transco has been required to re-negotiate its existing contractual arrangements for shrinkage gas.

The procurement of gas services

As part of the development of Transco's SO incentives, Transco has been given greater discretion in procuring services for the purposes of system balancing, capacity management and residual gas balancing. For example, in the case of entry capacity management, Transco is now able to enter into forward and option contracts for purchasing entry capacity ahead of the gas day.

As a consequence of this increased freedom, Transco has been required to prepare Procurement Guidelines and System Management Principles Statements. These statements are intended to aid transparency for market participants regarding the services that Transco is contracting for as well as to assist market participants in better understanding the principles that Transco will adopt in balancing the NTS.

Ofgem approved the form of both the Procurement Guidelines and System Management Principles Statement in September 2002. In approving the form of the Procurement Guidelines, Ofgem raised concerns that the document should contain more information about Transco's procurement of system management services, such as shrinkage gas.

In terms of shrinkage contracting freedom, modification proposal 0579 *"Facilitation of shrinkage provider to make NBP trade disposals"* was approved by Ofgem on 3 February 2003. The modification allowed the shrinkage provider to sell any excess of gas acquired for shrinkage purposes at the NBP. However, it also limited the volume of shrinkage gas that Transco was able to sell at the NBP to the quantity of shrinkage gas purchased at the NBP for any given gas day. In approving modification proposal 0579, Ofgem stated that Transco should ensure that it releases information on the procurement and sale of shrinkage gas through its Procurement Guidelines in order to aid market transparency.

Subsequently, in April 2003, Transco published its Procurement Guidelines Report for 1 April 2002 to 31 March 2003. In this report, Transco has provided details of its shrinkage gas procurement for the previous year including monthly details of the quantity of gas purchased, the purchase cost and the weighted average purchase price for that month. In addition, Transco has published details of its imbalance cash-out volumes and costs for the shrinkage account for the previous year.

The proposal

Network code modification proposal 0618 proposes that for each gas day where the shrinkage provider has contracted to buy or sell gas, certain information should be provided by Transco ahead of and after that gas day. Ahead of the gas day the following information would be required:

- Transco's unbiased estimate of shrinkage gas requirements for the next gas day in kWh/therms;
- The volume of shrinkage gas purchased and sold before the day;
- The number of buys and sells trades executed in respect of that gas day; and
- The delivery point of all shrinkage gas bought and sold, whether at the NBP or at the beach.

Transco would also be required to publish the following information after the gas day:

- Transco's final net shrinkage position in kWh/therms;
- The volume of shrinkage gas purchased and sold on the day;

- The total number of buys and sells trades executed in respect of that gas day;
- The weighted average price of all buys and sells;
- The delivery point of all shrinkage gas bought and sold, whether at the NBP or at the beach;
- The minimum price at which the shrinkage gas was bought;
- The maximum price at which the shrinkage gas was bought;
- The minimum price at which the shrinkage gas was sold; and
- The maximum price at which the shrinkage gas was sold.

Respondents' views

There were four responses to the consultation. Three of these respondents supported the modification proposal.

Respondents in support of the proposal noted that increased transparency in Transco's market operations under the shrinkage provider account would encourage competition between shippers, resulting in increased liquidity and better prices for the shrinkage provider. One respondent stated that improved information flows and improved liquidity would allow the development of better-structured risk management tools for Transco in its role as system balancer.

Some respondents added that the proposal would better enable Ofgem and market participants to monitor Transco's management of shrinkage and Transco to demonstrate the efficiency of its actions. A respondent noted that since 80 percent of the costs of shrinkage gas are passed on to shippers under Transco's SO incentives if Transco fails to procure shrinkage gas within the target level, shippers have a vested interest to make sure that Transco manages gas shrinkage in the most efficient manner.

One respondent noted that in its decision letter for modification proposal 0579, Ofgem stated that there should be greater transparency with respect to Transco's activities given its role as monopoly system operator and, in particular, with respect to the procurement and sale of shrinkage gas. This respondent believed that modification proposal 0618 is consistent with the views expressed by Ofgem. The respondent stated that Ofgem should take the lead in monitoring Transco's activities but took the view that this proposal would provide shippers with the ability to contribute to such monitoring.

Another respondent noted that the implementation of modification proposal 0579 has potentially provided Transco with the opportunity to take speculative positions with regards to the shrinkage provider account. This could give Transco the ability to affect market prices. In particular, it was noted that there is no limit to the quantity of shrinkage gas purchased ahead of the day which Transco could then dispose of on the gas day.

One respondent stated that the provision of shrinkage information ahead of the day could facilitate shippers' ability to forecast their system imbalances more accurately to the extent that shrinkage forecasts feed into this estimate.

One respondent believed that Transco has contracts in place with one or more shippers to buy and sell shrinkage gas. The respondent argued that these contracts place certain shippers at an informational advantage with regard to system shrinkage, demand and gas prices at which

Transco has traded. The respondent believed that the disclosure of information would ensure that all shippers have access to the same information in order to ensure a level playing field.

Some respondents challenged Transco's view that the shrinkage provider account is the same as any other shipper account on the system. One respondent argued that the shrinkage provider is at an advantage in having access to every shipper's AT link and imbalance account information, as well as shrinkage information, which it can use for its own advantage. Another respondent argued that shrinkage provision is a monopoly service which should be monitored and should have different information requirements when compared to competitive shippers. One respondent stated that there are no discrimination issues involved in a requirement for the shrinkage provider to give more information than other users as the shrinkage provider account is designed to manage a physical system requirement rather than to enable speculative trading. The respondent noted that shippers undertake activities for both physical and speculative reasons and therefore have different motivations.

One respondent stated that a recent modification to the Balancing and Settlement Code in the electricity market had enabled the release of day ahead zonal transmission loss information, which, it was contended, is the equivalent of shrinkage gas.

The respondent against the proposal recognised that Transco should publish certain shrinkage information such as the quantities of shrinkage gas requirements since these costs are ultimately borne by shippers and their customers. However, this respondent believed that a significant amount of this information is already published. The respondent did not believe that it was appropriate to disclose information on how Transco procures shrinkage gas as this could place Transco in the position of a distressed buyer. The respondent also believed that the system costs of implementing the modification proposal would not outweigh any potential benefits.

Transco's view

Transco did not support implementation of modification proposal 0618.

Transco believed that the release of ahead of the day and after the day information could reveal the trading position and strategy of the shrinkage provider, placing it in a distressed buyer position and increasing the risks associated with managing the shrinkage account. Transco stated that this could result in increased costs of managing the account to the detriment of both Transco and shippers and would not therefore assist in the efficient operation of the pipeline system.

With regards to the concerns expressed that the shrinkage provider can buy unlimited quantities of shrinkage gas Transco noted that it has obligations which prevent it from speculatively trading and require it to operate the system in an economic and efficient manner. Transco believed that these obligations coupled with regulatory monitoring should provide shippers with the assurance that shrinkage provision is managed in an appropriate manner.

Transco disagreed with the views expressed by the proposer that the shrinkage provider was a monopoly activity and noted that shrinkage provision could be undertaken by another party. Transco was of the view that the shrinkage provider account is not dissimilar to any other accounts and therefore it should not be singled out for information release obligations that do not apply to other accounts. Furthermore, Transco noted that the shrinkage provider account is insignificant in comparison to other trading accounts, representing less than 0.21 percent of the market. As such, Transco stated that the obligations in respect of providing extra information for such a small account would be unlikely to have any significant market efficiency benefits.

Transco noted that the publication of information would require significant resource commitment thereby generating costs that might be considered inefficient. These costs would be shared between Transco and shippers. Transco estimated that the development costs associated with setting up additional web pages could be in excess of £50,000 with ongoing reporting support also amounting to £50,000 per annum. Transco stated that it may be more efficient for resources to be directed at managing and reducing shrinkage volumes effectively. Transco also noted that it already provides a substantial amount of information with respect to the shrinkage provider account to shippers and Ofgem.

Ofgem's view

Ofgem has carefully considered the respondents' views and the issues raised by shippers and Transco associated with this modification proposal. Ofgem considers that the publication of further up to date information as outlined in this proposal could, in principle, provide additional transparency and competitive benefits. However, we are concerned that the publication of ahead of the day information about both the estimated shrinkage requirements and the shrinkage gas purchased for the following day, i.e. Transco's expected imbalance position under the shrinkage account, could place the shrinkage provider at a disadvantage to the extent that it is obliged to fulfil the network's daily gas shrinkage requirements. This could, in turn, increase the costs of managing the shrinkage gas account, thus hampering the efficient and economic operation by Transco of its pipeline system.

In this context, Ofgem considers that Transco, as shrinkage provider, would compete with other players in the wholesale market for the procurement of gas when its shrinkage requirements are not fully covered on a gas day. In this respect, Transco's position in the market could be weakened by revealing its potential shortfall or excess of shrinkage gas ahead of the day.

As indicated in its letter of 23 October 2003 on the disclosure of offshore information, Ofgem continues to believe that, generally speaking, information which is disclosed to the market on an ex ante basis should be at a level of aggregation which does not disclose an individual participant's commercial position. This would include Transco as shrinkage provider.

Further, modification 0599 *"Obligation on shrinkage provider to purchase gas at the NBP"* requires Transco to re-negotiate its present long term contractual arrangements for shrinkage gas by April 2004 when the modification becomes effective. As the outcome of this restructuring of Transco's contractual arrangements for the procurement of shrinkage gas is still uncertain, Ofgem has considered that this modification proposal could place an additional risk on Transco to the extent that it could be required to source a larger proportion of gas on the spot market.

Ofgem has also considered respondents' views about similar information which is being published by National Grid Company (NGC) on both a day ahead and after the day basis. In this respect, Ofgem believes that although NGC publishes ahead of the day information about the volumes and costs of electricity it has contracted for and provides broad operational planning margin requirements, it does not have an obligation to fulfil these reserve requirements. As regards the release of zonal transmission loss information, we consider that

NGC is not required to publish figures in any detail and currently the procurement mechanism for transmission losses is not market-based.

Notwithstanding these concerns, Ofgem still considers that proposals in line with modification proposals 0618 could bring, in principle, significant benefit to the efficient and economic operation of Transco's transmission system and could enhance competition between the relevant shippers and suppliers. As outlined in our decision letter of 11 October on Transco's Procurement Guidelines and reiterated in our decision letter on Modification 0579, *"Facilitation of Shrinkage Provider to make NBP Trade Disposals"*, Ofgem believes that there should be a greater expectation of transparency with respect to Transco's activities given its role as monopoly system operator.

Currently, Transco publishes information on the operation of its shrinkage account as part of its Procurement Guidelines Report. In this respect, Transco has already published its first report for the period 1 April 2002 to 31 March 2003. Transco also provides additional information to Ofgem on a weekly and monthly basis with regard to its activities under the shrinkage provider account. Ofgem nevertheless considers that the publication of further up to date information should better facilitate competition between shippers seeking to offer system balancing services to Transco.

Finally, Transco has expressed its intention to develop an alternative proposal to publish additional information about Transco's activities under the shrinkage provider account in line with the intent of modification proposal 0618. It is also open to shippers to raise new modification proposals in this area of the network code.

Ofgem's decision

For the reasons outlined above, Ofgem has decided to direct Transco not to implement network code modification proposal 0618 as we believe that the proposal does not better facilitate the achievement of the relevant objectives as outlined under 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 Samanta Padalino on 020-7901-7033.

Yours sincerely,

Kyran Hanks
Director, Gas Trading Arrangements