Direct Dial: 020-7901-7021

Transco, Shippers and other Interested Parties 16 August 2002

Our Ref: Net/Cod/Mod/529

Dear Colleague

Modification 529 "Treatment of Constrained Top-Up Costs for Storage Year 2002/03"

Ofgem has considered the issues raised in Modification Proposal 529 "*Treatment of Constrained Top Up Costs for Storage Year 2002/03*" and has decided not to direct Transco to implement the modification because we believe that it does not better facilitate the relevant objectives of Transco's Network Code. In this letter, we explain the background to the modification proposal, the nature of the proposal and give our reasons for making this decision.

Background

Under Standard Condition 13(1) of its GT licence, Transco is obliged to plan and develop its pipeline system such that it can meet the peak aggregate daily demand that is only likely to be exceeded once in every 20 years taking into account weather data derived from at least the previous fifty years. This is Transco's 1 in 20 requirement.

Transco meets this requirement through a number of measures, including investment in pipelines, the use of interruptible transportation terms and the use of gas storage facilities. In using gas storage facilities, Transco sets monitor levels at three of the five Liquefied Natural Gas (LNG) sites: Avonmouth, Isle of Grain and Dynevor Arms. These monitor levels represent Transco's estimate of the volume of gas in store needed at different times of the year to ensure that the security standards can be met. To ensure that the stock of gas at each site does not fall below the monitor level, Transco 'constrains' shippers' use of the gas they hold in store at these sites. Transco also has the right to direct shippers to deliver gas that they hold at constrained LNG sites onto the system under certain circumstances. Shippers that book capacity at a constrained facility receive a discount on their transportation charges (an NTS entry capacity rebate) in return for the constraints they face.

If shipper bookings are below the opening monitor level at a constrained site, Transco will purchase the required capacity and gas (acting as what is known as the 'Top-up Manager') to make up the difference. Top-up purchases of this kind are referred to as *'Constrained LNG Top-up'* (CLNG Top-up). The specific arrangements for Transco's procurement and usage of constrained LNG top-up are contained within Section P of its Network Code.

Transco's Network Code also contains arrangements for what is referred to as *'national top-up'*, and these arrangements are referred to in Transco's Safety Case as approved by the HSE. Under these arrangements, each year Transco assesses the potential for aggregate available supplies to meet its estimate of the 1 in 20 peak day demand, and the 1 in 50 winter load profile. Where a shortfall is identified, Transco, acting as top-up manager, will book and fill storage capacity to make up the difference.

Transco is currently permitted to recover the costs associated with purchases of CLNG top-up (but not national top-up) and the ability to do this has been subject to Ofgem's annual approval of the relevant network code proposals.[1]

The Proposal

Transco proposes the continuation of the Constrained Top-up cost recovery arrangements implemented (originally implemented through Modification Proposal 391 for the storage year 2000 / 2001, and Modification Proposal 451 for the storage year 2001 / 2002) for one further year, commencing 1 May 2002.

Respondents' views

Two representations were received in response to the proposal. Neither of respondents supported the implementation of the proposal.

Both respondents referred to the view put forward by Ofgas in our Review of Top-up conclusions document that the full costs of transportation constraints should be borne by Transco. They both argued that exposing shippers to the costs of constrained LNG top-up would remove any incentive from Transco to optimise between expenditure on top-up and capital expenditure, and would be contrary to the approach taken in Ofgem's proposals for Transco's System Operator incentive arrangements.

One of the respondents additionally noted that Transco continued to propose an unfocused smear of costs between shippers, arguing that such an approach to cost recovery was inappropriate as it did not target costs on those shippers that had failed to make adequate peak day provisions.

Transco's views

---

[1] For further details, please refer to Ofgem's decision letters for Modification Proposals 356, 391 and 472.

Transco argued that the costs associated with constrained LNG top-up bookings should be funded appropriately since these bookings are associated with a requirement to meet its GT Licence obligations concerning peak capacity provision. Transco argued that an inability to recover CLNG top-up costs could generate a perverse incentive to invest in new pipeline capacity rather than utilise existing LNG assets, despite the fact that using CLNG might be a more efficient method of providing for some peak capacity in some areas. Given this, Transco argued that implementing the modification would better facilitate the efficient and economic operation by the licensee of its pipeline system.

With regard to the comments made by the respondents who opposed the proposal, Transco expressed a view only in relation to the cost recovery process. It argued that it has considered a number of alternative approaches to cost recovery, but that neither Transco nor any other user has yet identified a method of apportionment that better facilitates the relevant objectives. Transco highlighted its willingness to consider any alternatives to the present methodology which users might wish to raise, but in the absence of any such alternative, suggested that the existing methodology should continue for an additional 12 months.

Ofgem's views

In accepting Modification Proposals 391 and 451, Ofgem considered that, given the increase in transportation rebates and the introduction of auctions, if CLNG top-up bookings were necessary, they would be consistent with Transco's obligation to operate an economic and efficient pipeline system, subject to the level of reserve prices not being such as to frustrate the objective of ensuring that all capacity is made available to the market. In making both decisions, however, Ofgem emphasised that arrangements for subsequent years would be considered as part of Ofgem's review of exit capacity, interruptions and LNG storage.

These arrangements have subsequently been considered as part of the development of Ofgem's proposals for Transco's system operator incentives from April 2002. Under the SO incentive arrangements put forward in Ofgem's final proposals, Transco is provided with a fixed allowance for each year of the control in relation to its use of CLNG. It was explicitly stated in initial and final proposals that additional funding for CLNG top-up over and above these fixed allowances was not appropriate. In particular, in the initial proposals document it was stated that:

"*Ofgem proposes that any costs associated with the purchasing of constrained LNG top up should be considered simply as part of the overall costs of providing constrained LNG, and therefore covered by the CLNG allowances set out in chapter 7. We propose therefore that no additional allowance be made" (para 9.46, p126)*[2]

The following comments made in the final proposals document reiterate this:

'Ofgem's initial target cost under the NTS incentive scheme included an allowance in respect of CLNG. Ofgem proposed that any costs associated with the procurement of CLNG top-up should be part of the exit scheme, so that Transco would have appropriate incentives to adopt the most efficient methods of addressing local transportation constraints"[3]*. (para 6.15, p69)*

Given the potential for distortions associated with Transco's ownership of the LNG facilities, the SO regime is designed such that at least for the first two years of the scheme Transco bears all CLNG costs above the allowance levels, but keeps all of any savings made below the allowance levels[4]. As noted in the quotation above, a central objective of the exit scheme in the proposed SO incentive arrangements is to ensure that Transco faces incentives to make efficient trade-offs between the usage of pipeline investment, interruption rights and constrained LNG in addressing transportation constraints. Allowing cost recovery for CLNG top-up costs – as proposed in this

---

[2] "Transco's National Transmission System – System Operator Incentives 2002-7: Initial proposals", Ofgem, September 2001 (p76).

[3] "Transco's National Transmission System – System Operator Incentives 2002-7: Final proposals", Ofgem, December 2001 (p69).

[4] The sharing factors and caps and collars associated with the constrained LNG costs would be subject to review after two years.

modification – would undermine this part of the SO regime by distorting those trade-offs. Ofgem, therefore, does not consider that this is consistent with better facilitating the efficient and economic operation by the licensee of its pipeline system.

Ofgem's decision

Ofgem has decided not to direct Transco to implement the modification, because we do not believe that the proposal will better facilitate the relevant objectives of Transco's Network Code.

If you have any queries in relation to the issues raised in this letter, please contact me on the number above or Amrik Bal on 020 7901 7074.

Yours sincerely

Kyran Hanks
Director, Gas Trading Arrangements