OFGEM DECISION LETTER No. 0540
"Delay of Licence and Effects on Capacity Incentives"
Version 1.0

Transco, Shippers and Other Interested Parties

Our Ref: Net/Cod/Mod/540
Direct Dial: 020 7901 020- 7437
Email: mark.feather@ofgem.gov.uk

28 March 2002

Dear Colleague,

Modification Proposal 0540 *'Delay of Licence and Effects on Capacity Incentives'*

Ofgem has considered the issues raised in Modification Proposal 0540 *'Delay of Licence and Effects on Capacity Incentives'*.

Transco raised this proposal on 5 March 2002 and requested that Ofgem grant it urgent status. Ofgem agreed that the proposal merited urgent status in a letter issued on 7 March 2002, after which Transco issued the proposal for consultation. Transco undertook to provide a copy of the final modification report to Ofgem on 22 March 2002. Ofgem received the final modification report on 25 March 2002.

Before proceeding to confirm the decision that Ofgem has reached in respect of this modification proposal, Ofgem considers that it is appropriate to clarify some matters surrounding the modification proposal.

Ofgem is concerned to note that some respondents raised the issue that these modification proposals sought prematurely to anticipate the outcome of the statutory consultation process under section 23 of the Gas Act 1986 to introduce changes to Transco's Gas Transporter's (GT) licence associated with Transco's price control for the period April 2002-7. Transco sought to address this perception by noting in its final modification report issued to the industry on 25 March 2002 that the proposed licence amendments in respect of the System Operator (SO) Incentive Final Proposals are to be the subject of a separate statutory consultation under section 23 of the Gas Act 1986 that has yet to be commenced and that no assumptions can be made in respect of the outcome of this process. While this is correct, Ofgem wishes to address any concerns that industry participants may have on this matter.

Any decision placed before the Authority under standard condition 9 (Network Code) of Transco's GT licence has to be assessed against the criteria set out therein having regard to the Authority's (and the licensee's) general duties and all relevant facts. In essence in respect of this modification proposal this means that it has to be assessed against the background of the licence and the network code as they exist today - not as they may be in the future as a result of a consultation process which has not yet commenced. There are circumstances where it may be appropriate to have regard to imminent changes to a licence or regulatory regime in order to assess whether the changes meets the relevant criteria. Here it is appropriate to note the existence of the SO Final Proposals but it is inappropriate to make assumptions about how these could be translated into licence obligations as these have yet to be consulted upon.

However, Ofgem considers it appropriate to confirm that it does intend to publish licence modifications for statutory consultation under section 23 of the Gas Act 1986 and that one possible consequence of that statutory consultation process is that further changes to Transco's Network Code **may** be necessary to implement changes to Transco price control (Transmission Asset Owner (TO) and SO) for the period 2002-07. Ofgem intends to commence this process shortly. It is important to stress that nothing in this decision nor any other document precludes any signatory to the network code raising modifications on this or any other matter in the future.

In reaching its decision on whether this modification proposal meets the criteria set out in standard condition 9 of Transco's GT licence, Ofgem has noted that Transco has stated that the rationale behind the decision is to facilitate the implementation of the SO final proposals. This is not possible for the reasons stated above. The basis for considering whether to direct that this modification be made is set out in standard condition 9 of Transco's GT licence. Having regard to the criteria set out there and for the reasons set out in the Ofgem views section of this letter, Ofgem has decided to direct Transco to implement this proposal.

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

Background to the proposal

Entry capacity arrangements

Transco has allocated monthly system entry capacity (MSEC) rights to access its National Transmission System (NTS) through six-monthly auctions since September 1999. In addition to these auctions, Transco also makes firm and interruptible capacity available on a daily basis where there is additional capacity physically available. Capacity is sold at the day-ahead stage and within the gas day. In addition, any unsold capacity from the monthly auctions is available as an 'off-the-shelf' product for purchase up to three days in advance of the beginning of the relevant month.

In the event of a constraint at an entry point (when physical capacity is less than capacity sold against which gas is flowing) Transco can reduce capacity availability by either scaling back interruptible capacity or buying back firm capacity until the constraint is relieved.

Transco capacity incentives

Transco currently has financial incentives which are designed to ensure that Transco manages the costs of any buy-backs and releases all physically available entry capacity to market by selling additional capacity day-ahead and within-day.

Transco's current buy-back incentive was introduced following Ofgem's acceptance of Modification Proposal 0488, *'Redesign of Capacity Incentive Regime'* on 24 August 2001. Under this incentive arrangement, Transco is subject to a Capacity Incentive Performance Measure (CIPM), which is based on the magnitude of the net cost (revenue) of actual costs of capacity buy-backs and incremental sales revenue for a month, compared to an ex ante agreed target level of buy-back costs. A target of £60 million was set for the six month period to 31 March 2002.

Where the CIPM is equal to zero (ie, actual net costs are equal to the target), Transco will face no reward or penalty. Superior performance occurs when actual net costs are lower than target, in which case Transco will benefit from incentive payments in accordance with the upside sharing factor, subject to the cap. Conversely, inferior performance occurs when actual net costs exceed the target, in which case Transco will be liable to make incentive payments in accordance with the downside sharing factor, subject to the collar. Under the incentive Transco is exposed to a maximum risk and reward of +/- £416 000 per month.

Under this arrangement, the costs of capacity buy-backs and the revenues from incremental capacity sales are passed through to shippers via the capacity neutrality arrangements. In particular, the costs of buy-backs are borne by holders of MSEC capacity across all terminals in proportion to their holdings of capacity and the revenues from incremental capacity sales at individual Aggregate System Entry Points are passed through to holders of MSEC at those individual ASEPs.

The incentive introduced through modification 0488, was implemented following Ofgem's acceptance of modification proposal 0481, *'Release of ASEP Maximum System Entry Capacity Volumes for MSEC Auction'*. This modification provided for a significant increase in the volumes of capacity released in the MSEC auction for the period October 2001 to March 2002 and effectively changed the balance of risk and reward under the previous capacity incentive regime thus indicating that a change to the incentive may be appropriate.

Ofgem would also note that following its acceptance of modification proposal 0499, *'Transition Arrangements for Long Term Capacity Allocation'*, the volumes of capacity offered for sale in the recently completed February 2002 entry capacity auctions for the period April to September 2002 were based on a significant proportion of the maximum physical capacity of the NTS. In particular, these volumes were set at 90% of a series of baseline entry capacity output measures as defined under Transco's TO price control for the period April 2002-7. *Review of Transco's Price Control from 2002, Final proposals*, September 2001. The NTS TO control baseline entry capacity outputs were set at the maximum physical entry capacity at each entry point to the NTS.

Treatment of incentive payments and rewards

On 18 January 2002, Ofgem decided not to veto Transco's Pricing Consulation (PC) 70, *'Proposal for NTS System Operation Transportation Charges'*. PC70 replaces the NTS standard commodity charge with an SO commodity charge which is to take effect from 1 April 2002 and which will be levied on the basis of exit flows from the NTS. From 1 April 2002 Transco intends to use this charge to recover the payments and rewards associated with its system operator incentives.

The incentive arrangements introduced following acceptance of Modification Proposal 0488 cover the period from 1 October 2001 to 31 March 2002. In the absence of changes to the Network Code, such as contained in this proposal, the incentive arrangements that would apply to Transco would be those as introduced on 1 October 1999. Under these arrangements, Transco retained 20% of any additional revenue associated with the sale of daily firm and interruptible capacity. Conversely, Transco was liable for 20% of the costs of buy-backs. Transco's gains and losses under this scheme were capped annually at £5 million and divided into equal monthly caps.

The proposal

This proposal provides for the implementation of a revised capacity buy-back incentive to take effect from 1 April 2002. The proposed incentive parameters are:

- Target - £35 million cost
- Cap - £30 million revenue to Transco
- Collar - £12.5 million cost to Transco
- Upside sharing factor – 50%
- Downside sharing factor – 35%

Under the proposed incentive, Transco would be subject to a Capacity Incentive Performance Measure (CIPM), which is the magnitude of the net cost, or revenue, of actual costs of capacity management and incremental sales revenue for a formula year compared to the target value.

The proposal further provides that capacity management costs and incremental sales revenue will be redistributed via capacity neutrality arrangements.

However, incentive costs and revenues under this scheme will be reflected in a SO commodity charge (as proposed in PC70) and this proposal provides that the existing billing arrangements associated with the payment (receipt) of incentive revenues to (from) Transco will cease.

Respondents' views

The majority of respondents supported the proposal. However, many of these respondents qualified their support.

One respondent accepted that it would not be appropriate to continue with the current regime in the Network Code, as this would not be representative of the commercial incentives which Transco 'will now be subject to'. However this respondent was nevertheless concerned about the risks associated with changing users' and Transco's systems at short notice. This respondent indicated that the interim proposals raised by Transco add uncertainty to shippers' operations.

In addition, this respondent expressed concern that no further information has been available on the proposed amendments to Transco's GT licence. This concern was shared by a number of other respondents, one of whom suggested that shippers have been presented with partial information and an incomplete process, which it said was unacceptable, while another respondent said that it made it difficult to comment meaningfully on this proposal.

One respondent believed that it differed in its interpretation of the way in which incremental sales revenue would be measured under the new SO incentive scheme. This respondent understood that Transco would be rewarded for capacity released above baseline levels only and would not be rewarded for releasing baseline capacity on the gas day.

A number of respondents also indicated that there was insufficient understanding amongst industry participants of the revenue flows under the new regime. One of these respondents also requested clarity on the interrelationships between the various SO incentive components, the relationship between Transco's SO and TO roles and Transco's trading role.

One respondent suggested that there was a need to consider the treatment of buy-backs to manage maintenance or compressor failures and whether this should be ring-fenced from the performance incentive.

One respondent who supported the proposal agreed that clarity was needed regarding how the capacity buy-back arrangements will work from 1 April 2002.

While one respondent felt that the proposal was necessary to 'prevent detailed and complicated retrospective reconciliation arrangements', other respondents noted that there would still be the risk of a need for reconciliation, depending on the exact form of the licence amendments.

Several respondents requested clarity on whether any changes implemented by the proposal would be removed from the Network Code once any proposed licence amendments are implemented. One respondent suggested that a further Network Code modification may be required to remove the effects of this modification, once the licence amendments are finalised.

Two respondents, in supporting the proposal, stated that the incentives should remain permanently in the Network Code. One of these respondents added that defining the incentive parameters in the Network Code would give market participants (who fund the incentives) the opportunity to amend the incentives if they are too favourable to Transco. This respondent believed that the current difficulties in making timely changes to Transco's GT licence illustrated that it is inappropriate and inflexible to hard-code of trading arrangements rules into the licence.

Two respondents opposed the proposal. One stated that due process required that until the preceding matters of licence changes are finalised and accepted, the arrangements set out in this proposal could not and therefore should not be implemented. It also felt that this meant that it was unable to comment meaningfully on the proposal and in addition felt that it was unacceptable for Transco to seek to introduce changes to the Network Code while it was effectively hedging its own commitment to these changes.

The other respondent expressed concerns about the process being adopted to implement Transco's price control and associated SO incentives and recommended that Ofgem and Transco seek alternative approaches to resolving the problems associated with implementing the licence conditions to take effect from 1 April 2002.

Transco's view

Transco has stated that this modification is necessary so that the structure and parameters of Transco's buy-back incentive are consistent with Ofgem's final SO proposals, which it expected to be reflected in its GT licence 'in due course'. As such, while noting that the proposed licence amendments are to be the subject of consultation under s23 of the Gas Act 1986 and that no assumptions could be made regarding the outcome of that process, Transco stated that the proposal facilitated compliance with the relevant objective of the efficient discharge, by Transco, of obligations under its GT licence.

In addition, Transco stated that failure to make the modification would result in uncertainty in that the Network Code would contain different incentives to the intent of the SO proposals and that complex reconciliation arrangements might then be necessary if SO proposals were subsequently implemented through Transco's GT licence with retrospective effect.

Ofgem's view

As discussed above, under the existing provisions of the network code, the capacity incentive introduced through modification 0488 will lapse on 31 March 2002. In the absence of any changes therefore the incentive regime that will apply from 1 April 2002 is that which existed prior to the implementation of modification 0488 whereby Transco retains 20% of the revenues associated with daily capacity sales and bears 20% of the costs associated with capacity buy-backs (subject to monthly caps and collars).

Ofgem does not consider that the application of this incentive would be appropriate in circumstances where Transco has based its release of capacity on close to maximum physical capacity levels for the period 1 April to 30 September 2002. In particular, the release of capacity based on near maximum physical levels has significantly altered the balance of risk and reward to Transco under this incentive relative to the risk and reward balance that prevailed in circumstances when Transco released significantly lower MSEC volumes under the SND methodology. In this respect, Ofgem considers that the application of the original capacity incentive arrangements is inappropriate in circumstances where the potential for buy-backs is higher than was previously the case.

Instead, Ofgem considers that an approach based on a target level of buy-back costs is more appropriate given the release of capacity based on a proportion of maximum physical levels. In this respect, given the amount of capacity released in the February 2002 auctions, Ofgem considers that this proposal would provide Transco with a better incentive to manage the costs of capacity buy-backs.

Ofgem would also note that the incentive that Transco has proposed provides it with a deeper incentive relative to that introduced by modification 0488 and therefore greater potential rewards as well as increased risk exposure.

Ofgem does not accept the position outlined by Transco in its final modification report that the changes proposed in this modification would facilitate compliance with the relevant objective of the efficient discharge of Transco's obligations under its GT licence. In particular, Ofgem considers that it is not possible to determine whether the modification better facilitates this objective in circumstances when the proposed modifications to Transco's licence are to be the subject of a consultation that has not yet occurred.

As outlined previously Ofgem intends to issue the consultation on the proposed modifications to Transco' GT licence shortly. Any modifications to Transco's GT licence are therefore subject to this consultation process. Accordingly, it is incorrect to assume that such changes will be implemented and to judge this proposal against Transco's 'anticipated' licence obligations.

As noted previously, any decision placed before the Authority under standard condition 9 (Network Code) has to be assessed against the criteria set out therein having regard to the Authority's and the licensee's general duties and all relevant facts. In essence in respect of this modification proposal this means that it has to be assessed against the background of the licence and the Network Code as they exist today, not as they may be in the future as a result of a consultation process which has not yet commenced.

Further, as noted above, in reaching its decision on whether this modification proposal meets the criteria set out in standard condition 9 of Transco's GT licence, Ofgem has noted that Transco has stated that the rationale behind the decision is to implement the SO Final Proposals. This is not possible for the reasons stated above. The basis for considering whether to direct that the modification be made is set out in standard condition 9 of Transco's GT licence.

Ofgem's decision

For the reasons outlined above Ofgem has decided to direct Transco to implement this modification proposal because we consider that it better facilitates 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.

Yours sincerely,

Mark Feather
Head of New Gas Trading Arrangements