OFGEM DECISION LETTER
0532, 0545, 0547.

Version 1.0

19 February 2003

Dear Colleague,

Application of SO Commodity Charge to storage facilities

Of gem has carefully considered the issues raised in modification proposal 0532, *'Application* of *SO Commodity Charges to all NTS Loads',* modification proposal 0545, *'Application* of *SO Commodity Charges to Storage Facilities'* and modification proposal 0547, *'Reconciled SO Commodity Charges* at *Storage Facilities'.*

These modification proposals were raised as alternative proposals to apply the National Transmission System (NTS) System Operation (SO) commodity charge to storage flows.. Ofgem has considered the issues raised in these proposals and has decided not to direct Transco to implement any of the three proposals. In particular, Of gem does not consider that the proposals better facilitate the relevant objectives of Transco's network code. The reasons for our decision are set out in the attached paper.

Following Ofgem's decision not to veto Pricing Consultation (PO 70, *'NTS System Operation Transportation Charges',* the NTS SO commodity charge has applied from 1 April 2002 on the basis of gas offtaken from the NTS. From 1 October 2003, following Ofgem's decision to not veto PC 73, *'Structure* of the *NTS SO Commodity Charge',* the NTS SO commodity charge will apply on a 50:50 basis to both entry and exit flows from the NTS. Whilst following the implementation of PC73, storage flows are specifically included as a type of flow to which the SO commodity charge should apply, it is necessary to effect a change to the network code to apply the charge to storage flows.

Ofgem continues to believe that, in principle, storage flows should not be excluded from .the application of the SO commodity charge and that any particular benefits provided by storage sites to Transco as system operator should not be factored into the calculation of the SO commodity charge. Instead, any such benefits, to the extent that Transco values them should be reflected in system management services agreements.

As such, whilst we are rejecting the above proposals, we would welcome a further proposal to amend the network code to apply the SO commodity charge to storage flows. In raising a further proposal, Ofgem considers that regard should be had to the matters outlined below.

Any *new* proposal should seek to recover the costs associated with physical flows *onto* the NTS from storage and out of the NTS into storage. In this respect, Ofgem notes that there are some merits in the proposal put forward by Transco in modification 0532 in so far as it focussed upon identifying net physical flows on an end of day basis for charging purposes. As is noted in the attached paper, Ofgem does not believe that yearly approaches in which entry and exit flows are netted off from each other to determine charging volumes are cost reflective.

For the reasons outlined in the attached paper, Ofgem also considers that storage users should not bear an unreasonable share of the overheads associated with the operation of T ransco's system through the SO commodity charge merely as a consequence of storing their gas. As such, without fettering our discretion with respect to future changes to Transco's network code or pricing methodology, Ofgem believes that consideration could be given to applying a discounted SO commodrty charge to storage users so as to minimise the potential for double charging.

If you have any queries in relation to the issues raised in this letter or the attachment, please feel free to contact me on the above number or Mark Feather on extension 7437 or lyn Camilleri on extension 7431.

Yours sincerely,

Kyran Hanks
Director, Gas Trading Arrangements

Background on proposals to apply the NTS SO commodity charge to storage flows

Ofgem decided not to veto Pricing Consultation (PC) 70, *'NTS System Operation Transportation Charges',* on 18 January 2002. This pricing consultation replaced the National Transmission System (NTS) standard commodity charge with a System Operation (SO) commodity charge, to recover target SO revenue. The new SO commodity charge took effect from 1 April 2002. The SO commodity charge recovers allowed SO revenue (including system balancing costs, NTS SO internal costs and the revenues or payments arising from the NTS SO incentive schemes).

The SO commodity charge is applied to all gas offtaken at exit points from the NT5, subject to any restrictions imposed by the network code. Accordingly, a particular effect of PC70 was that the SO commodity charge should apply, in principle, to exit flows into storage facilities. However, a change to the network code is necessary before the S0 commodity charge can apply to storage flows. In reaching its decision on PC70, Ofgem commented that shippers flowing gas into storage should not be treated differently to other users of the NT5 in bearing a proportjon of throughput-based charges. It is also noted that offtakes of gas from the NT5 via either the Irish or Belgian interconnectors attract the S0 commodity charge on the basis of daily offtake quantities.

The previous NTS commodity charge specifically excluded application to storage flows. Only gas consumed within the storage facility ('own-use gas'), for purposes such as process heating, attracted the charge. Own-use gas now attracts the SO commodity charge.

Following Of gem's decision on 30 July 2002 to not veto PC 73, *'5trudure of the NT5* 50 *Commodity Charge',* the S0 commodity charge will be levied on gas entering the NTS at system entry points, as well as gas offtaken at exit points from the NT5, on a 50:50 basis, from 1 October 2003.

Transco raised network code modification proposal 0532, *'Application of* SO *Commodity Charge to an NTS Loads',* on 14 February 2002, in order to apply the SO commodity charge to storage flows. This proposal was developed through the Energy and Capacity workstream process, during which three alternative proposals ..vere raised. Dynegy UK ltd raised network code modification proposal 0545, *'Application* of SO *Commodity Charges to Storage Facilities',* on 18 March 2002. Aquila Energy raised network code modification proposal 0546, *'Application* of SO *Commodity Charges to Storage facilities',* but on 18 October 2002 withdrew this proposal. Entergy-Koch Trading Europe ltd raised network code modification proposal 0547, *'Reconciled* SO *Commodity Charges at Storage Facilities',* on 8 April 2002.

Modification proposal 0532 *'Application of* 50 *Commodity Charges* to *all NT5 Loads' The proposal*

Transco's original proposal was to apply the SO commodity charge to all offtake points on the basis of User Daily Quantity Outputs (UDQOs). In respect of storage flows, UDQOs represent gas injected into a storage site from the NTS. Transco submitted that this would equal the physical quantity of gas off-taken at a storage site, provided there had been no entry nomination (ie, associated with a storage withdrawal nomination) on that day.

This original proposal was developed into four alternative methodologies. These alternatives were:

1. charge each user the SO commodity charge on the basis of UDQOs without any adjustment; 2. charge each user the SO commodity charge on the basis of UDQOs, with a rebate paid to users who withdraw gas from storage on that gas day;
3. charge users injecting gas into storage on a gas day in proportion to the net physical flow into the storage facility on that gas day;
4. charge users injecting gas into storage on a gas day in accordance with allocations notified by the storage operator to Transco, provided that the sum of the allocations notified equalled the net physical flow into the storage facility.

After evaluating all four alternatives, the workstream favoured alternative 3, but representations were sought on all alternatives.

In response to representations, in its final modification report, Transco provided for interconnector flows to be treated consistently with storage flows, as set out in alternative 3

Respondents' views

There were 12 responses to the proposal, with the majority opposed to the alternative 3 methodology .

Cost-reflectivity and recognising the value of *storage*

A number of respondents considered that the proposal was not cost reflective and did not recognise the benefits that storage flows provided to system balancing and system security

One of these respondents argued that only a small proportion of SO costs, for example, compression, are directly related to throughput, while the majority of SO costs relate to general system costs that do not vary significantly with throughput. It argued that costs that are related to flows should be charged back to those users that cause the costs to be incurred and other system costs should be spread across all users. On this basis it argued that storage sites should not pay the SO commodity charge and should only be charged for those costs that Transco incurs at the relevant exit point.

The respondent also commented that, in relation to the recovery of these other system costs, storage sites are different from other exit points, because any gas injected into a storage site must have already entered the NT5 and any gas withdrawn must ultimately leave the NTS. On this basis the respondent argued that levying the S0 commodity charge on storage flows involves double charging. These concerns were shared by another respondent that identified that it would have to pay the commodity charge on several occasions in delivering a therm of gas from the beach to an end user.

Another respondent commented that the SO commodity charge should only apply to physical flows where it can be argued that Transco incurs system operation costs. One respondent commented that a detailed examination was necessary to determine the costs attributable to storage to ensure that a cost reflective charge was developed that encouraged new storage facilities to be built as well as the efficient use of Transco's system.

A minority of respondents supported the proposal and argued that SO costs should be recovered on the basis of all gas transported through the NTS, because gas injected into storage effectively uses the transportation system twice. These respondents indicated a preference for alternative 1 partly on the basis of its simplicity. They argued that levying the flow charge on the basis of net flows into storage on a day creates difficulties because shippers would not be able to predict the level of charges based on this method and because it would also be difficult for Transco to predict the level of the charge. By contrast, one respondent indicated its support for alternative 3 on the basis that it applied only to gas that has physically flowed.

A number of respondents argued that, while storage may provide benefits to Transco, it was not unique in this regard, while one respondent suggested that consideration could be given to a specific credit to recognise any unique benefits provided by storage sites.

Treatment of interconnectors

A number of respondents opposing the proposal stated that the proposal would entail inconsistent treatment between storage and interconnectors, while one respondent supporting the proposal expressed concern that the proposal would set a precedent for a change to the treatment of the interconnectors.

Treatment of *different storage sites*

A number of respondents commented that the proposal would imply differential *treatment* for drfferent storage srtes. One respondent argued that the proposal would discriminate against users of storage sites that have multiple users in favour of single owner sites, thereby damaging competition in the provision of storage services. Another respondent argued that the proposal would discriminate against smaller sites where a single shipper may withdraw and inject..

Other issues

Several respondents raised concerns that any changes to the SO commodity charge to address storage flows should be delayed until the outcome of PC73 was known. In particular, respondents were concerned that any changes to the SO commodity charge mechanism to address storage flows could become obsolete following the implementation of PC73.

Transco's views

Transco argued that the proposal would remove potential discrimination between storage users and non-storage users. Transco considered that charging on the basis of daily quantities, rather than flows based on a longer period, was preferable in terms of cost reflectivity. It argued that SO costs may arise on one day where gas is transported to a storage facility and similar1y costs would arise on another day when that same gas is transported from the storage facility to another exit point. It argued that charging on the basis of both of these flows would be cost reflective.

However, Transco stated that a disadvantage of its proposal was that it did not recognise the benefits that storage may provide to the system. While it considered that there may be merit in debate on the potential role of storage to security of supply and whether additional incentives to encourage storage development would be justified, it believed that such incentives should not be incorporated within the SO commodity charge.

Transco stated that there would be merit in aligning the implementation of the proposal with the implementation for PC73.

Of gem's views

In Ofgem's decision letter on PC 70, we agreed in principle that the SO commodity charge should apply to all NTS flows, including the flows into storage sites. However, recognising that some respondents had raised concerns with the methodology for applying the charge to storage flows, Ofgem considered that these concerns could be further considered in network code discussions. In the absence of a change to the network code, storage flows cannot attract the SO commodity charge.

Benefits provided by storage

As noted in Of gem's letter on PC70, storage flows may, in certain circumstances, assist Transco in efficiently and economically balancing its system. In particular, storage flows may provide national and locational gas services to Transco within short delivery times, thereby assisting Transco in balancing the NTS. In this respect, Of gem continues to believe that Transco's SO incentive package provides it with the financial incentives to purchase services of this nature where it is efficient to do so thereby rewarding the providers of these services. In this way, any particular benefits provided by storage flows can be specifically recognised.

However, Ofgem considers that the storage sites are not necessarily unique in the benefits that they provide in terms of system operation. As pointed out by some respondents, other 'Joads' such as generators can provide similar benefits to Transco's network. Whilst increased gas may be withdrawn from storage during periods of peak demand there may also be circumstances where large loads reduce their demand for gas in response to peak prices potentially benefiting Transco's network.

Accordingly, Ofgem continues in principle to remain of the view that the SO commodity charge should apply to storage flows. However, it should also be recognised that any such charge should be cost reflective in nature. The issue of cost reflectivity is discussed below.

Electricity interactions

Of gem would also note that users of pumped storage facilities do not benefit from any exemptions from NGC's BSUOS charges in the electricity sector. In this sense, the proposed application of the SO commodity charge to storage flows would bring some degree of consistency with the electricity sector.

Cost reflectivity

Having carefully considered respondents' views to this proposal, Of gem does not believe that the methodology proposed for applying the SO commodity charge to storage facilities is sufficiently cost reflective and does not therefore better facilitate the securing of effective competition between shippers.

The S0 commodity charge recovers a number of Transco's costs of system operation, a substantial portion of which are in the nature of overhead costs, which do not vary with throughput. Ofgem considers that to apply these costs to flows from the NT5 into storage facilities and apply the charge again when gas is offtaken from the NT5 (having been withdrawn from the storage facility), implies an element of double-charging. Ofgem considers that the double charging of storage facilities according to throughput is inappropriate given the proportion of general system operation costs that are levied through the SO commodity charge which are not related to gas flows. In particular, Ofgem is concerned that were the charge to be applied in the manner proposed, shippers using storage facilities would be exposed to a level of charge that is too high relative to the costs incurred by Transco and would therefore be disadvantaged relative to other shippers. On this basis the charge would not better facilitate the securing of effective competition between shippers.

Treatment of interconnectors

In Transco's final modification report, it has proposed to change the treatment of the interconnectors in the application of the SO commodity charge, to be consistent with the treatment of storage flows detailed in this proposal. Ofgem considers that this is an important issue, which needs to be fully consulted on before any change in treatment is made.

Of gem's decision

For the reasons outlined above, Ofgem has decided to direct Transco not to implement this modification proposal because we do not consider that it would better facilitate the relevant objective of securing effective competition between relevant shippers and between relevant suppliers, as contained in Amended Standard Condition 9 of Transco's GT licence.

Modification Proposal 0545 'Application of SO commodity charges to storage facilities'

The proposal

Dynegy UK Ltd proposed to apply the S0 commodity charge to flows of gas exiting a storage site, whilst imposing an equivalent credit on gas entering back onto the NT5. The proposal sought to charge individual shippers on the net physical flow of gas entering and exiting the NT5 from a storage site, based upon UDQOs (attracting a charge) and User Daily Quantity Inputs (UDQIs) (attracting a rebate) over a gas year.

Respondents' views

The majority of respondents did not support this proposal. In this section Ofgem has only summarised the responses of those respondents that commented specifically on modification proposal 0545, on the basis that any general comments on the issue of applying the SO commodity charge to storage users are summarised above in the context of modification proposal 0532.

Cost-reflect;vity

A number of respondents considered that basing the application of the SO commodity charge on a yearly basis did not reflect the cost drivers of Transco's daily operation of the NTS and considered that the charge should be applied to storage flows on a daily basis.

A number of respondents considered that, as with modification proposal 532, this proposal involved an etement of double charging of storage flows.

Some respondents stated that the proposal better reflected the value that storage facilities have on balancing the NTS. One respondent indicated however that it preferred the concept of monthly charging rather than the proposed yearly assessment of net injection. The respondent indicated that this would be more practical in accounting terms and easier to administer.

Consistency with PC 70

A number of respondents considered that the proposal undermined the intent of PC 70 to apply the SO commodity charge to storage flows.

Transco's views

Transco did not support this proposal. It considered that it was more cost reflective to apply the SO commodity charge on the basis of daily flows, because it stated that SO costs tend to be associated with physical flows on individual days. It also considered that the implementation of this proposal would negate the intended effect of PC 70, by allowing storage users to net off flows and thereby avoid an SO commodity charge.

Transco agreed that storage assists in the maintenance of system security. However, it indicated that it is difficult to argue that this contribution is different to other means of matching supply and demand such as interruption.

Transco stated that the payment of rebates would require a change in Transco's transportation charging methodology which would require consultation.

Of gem's views

Ofgem's views expressed above in relation to modification proposal 0532 on recognising the benefits provided by storage also apply to this proposal. Similarly, the concerns raised by Ofgem regarding cost reflectivity and the impact of double charging the SO commodity charge to users of storage facilities also apply to this proposal.

In addition, Of gem considers that the methodology of applying the S0 commodity charge on the basis of yearly flows whereby a credit is applied to gas re-entering the NT5 is not cost reflective and is arbitrary in nature. In particular, the application of this methodology could result in no S0 commodity charge at all being applied to physical flows in and out of a storage facility over a year, even though those flows may have contributed to Transco's costs of system operation to the extent that these costs vary with throughput. In this respect, Of gem notes Transco's statement that the cost drivers of its operation of the

NTS are daily and that the application of the charge on a yearly basis does not reflect its operation of the NTS.

Accordingly therefore, Ofgem does not consider that the implementation *of* a non-cost reflective methodology *of* this nature would better facilitate competition between shippers or suppliers and could result in cross-subsidies in favour *of* storage users.

Of gem also accepts that the proposal may create perverse incentives for shippers to flow gas in and out of storage in such a way to avoid incurring the SO commodity charge, or to obtain a net credit against its liability to pay the SO commodity charge. This would not better facilitate the efficient and economic operation of Transco's system.

Of gem's decision

For the reasons outlined above, Ofgem has decided to direct Transco not to implement this modification proposal because we do not consider that it would better facilitate the securing of effective competition between relevant shippers and between relevant suppliers or the efficient and economic operation by Transco of its system, as contained in Amended Standard Condition 9 of Transco's GT licence.

Modification Proposal 0547 'Reconciled SO commodity charges at storage facilities'

The proposal

Entergy-Koch Trading Europe Ltd proposed to apply the reconciliation mechanism used for exit points following the recovery of actual allocated flows, in order to determine aggregate annual (gas year) net flows. Shippers who had a net injection into a storage facility would attract a charge (which may be negative). The total charge to be applied would be equal to the net aggregate flow multiplied by the SO commodity rate. This would be allocated to the net injecting shippers on a pro-rata basis. If the net aggregate flow is negative, then no charge would be applied.

Respondents' views

The majority of respondents did not support this proposal. In this section, Ofgem has only summarised the responses of those respondents that commented specifically on modification proposal 0547, on the basis that any general comments on the issue of applying the SO commodity charge to storage users are summarised above in the context of modification proposal 0532.

As with modification proposal 0545, a number of respondents commented that the proposal did not reflect the costs of operating the transportation system on a day to day basis.. One respondent noted that under the proposal the charge would be reconciled annually at the end of each gas year whereas the SO commodity charge has been set to recover costs on a daily basis in the context of the price control year.

One respondent indicated that the proposal might create inappropriate incentives on storage users. This respondent also commented that the proposal would create a cross-subsidy from non-storage users to storage users and would be discriminatory thereby undermining competition between shippers.

One respondent in support of the proposal indicated that the methodology was cost reflective The respondent indicated that charging all users a commodity charge for parking their gas or balancing effectively is subsidising the system. Another respondent commented that the net flow approach contained in modification proposal 0547 is simpler than that contained in modification proposal 0545 and most cost reflective than modification proposal 0532.

Transco's views

Transco did not support this proposal. While recognising the benefits that storage provides to users, it stated that the value of storage to Transco was limited, other than on peak demand days or days associated with supply or transmission failure. It argued that this was due to the long durations typically associated with injectjon and withdrawal.

As with modification proposal 545, Transco objected to the annual charging basis used in this proposal, because it argued that its SO costs tend to be associated with physical flows on individual days. Transco considered that the proposal would lead to non-storage users subsidising storage users and was less cost reflective than modification proposal 0532 which based charging on daily flows.

Ofgem's views

Of gem's views in relation to modification proposal 545 also apply to this proposal.

Ofgem's decision

Of gem has decided to direct Transco not to implement this modification proposal because we do not consider that it would better facilitate the objectives of the securing of effective competition between relevant shippers and between relevant suppliers or the efficient and economic operation by Transco of its system, as contained in Amended Standard Condition 9 of Transco's GT licence.