Shippers, Transco and Other Interested Parties

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Dear Colleague,

Modification Proposal 523 – "Recovery of Financing Costs for Operating Margins"

Ofgem has considered the issues raised in modification proposal 523, *"Recovery of Financing Costs for Operating Margins",* and has decided not to direct Transco to implement the modification. 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

As part of its Safety Case established under the Gas Safety (Management) Regulations 1996, Transco is required to hold gas in store to deal with the effects of:

- a sudden change in within-day demand;
- an off-shore failure;
- an on-shore plant failure; and
- the orderly rundown of the transmission system under firm load-shedding conditions.

The requirement to hold gas in store in these circumstances is necessary to provide within-day support to maintain pressures within safe limits. Stored gas held by

Transco for these 'system reserve' purposes is known as 'Operating Margins' (OM) gas. The costs associated with OM gas can be split into two categories: storage capacity costs and commodity costs. At present, Transco is able to recover both categories of costs but in different ways.

The storage capacity costs associated with Transco's bookings of OM gas are recovered through Transco's allowed revenues. Under Transco's NTS System Operator (SO) incentives for the period 1 April 2002 to 31 March 2007 as set out in Transco's Gas Transporter's (GT) licence, Transco receives a fixed allowance or target for OM storage capacity costs[1]. Under the incentives, Transco is fully exposed to the extent that OM storage costs exceed this figure.

Equally, to the extent that OM storage costs are lower than the target, Transco receives the full benefits of these costs savings. The existing target has been set for a 2 year period to 1 April 2004 and as such will be reviewed in 2003 along with a number of Transco's other day to day system operator incentives. Full details of Transco's system reserve incentive can be found in '*Transco's National Transmission System system operator incentives 2002 – 07, Final Proposals, Ofgem, December 2001.*'

The commodity costs of Transco's OM bookings, however, are recovered in a different way. Under the network code, Transco is permitted to adjust the Daily Margins Recovery Amount in the calculation of Balancing Neutrality Charges – the calculation of which is covered in Section F of the code – on the days when OM gas been used. Transco then smears the resulting charge on shippers, thus recovering the commodity costs of its OM usage.

Transco is of the view that it incurs financing costs for OM gas due to the time lag between its purchases of the gas and its subsequent cost recovery (which occurs only after the gas has been used). In this respect, Transco indicated during the development of its SO incentives that it should be provided with an allowance for financing the costs associated with holding gas in storage. However, Ofgem did not include an allowance for financing costs. In this respect, Ofgem indicated that if Transco believes that the current network code arrangements inadequately reflect the costs incurred through the provision of system reserve gas then it should

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[1] Transco's SO incentives for April 2002 to March 2007 were implemented on 27 September 2002 with effect from 1 April 2002.

demonstrate the case for a financing allowance through the network code modification process.

The modification proposal

It is proposed to amend the network code so that Transco may recover the financing costs it incurs in making available quantities of gas for OM purposes. It is proposed that OM financing costs would be included in the calculation of the Daily Margins Recovery Amount, which is included within the balancing neutrality provisions of the network code.

Respondents' views

There were two responses to this modification. One respondent considered that, in principle, Transco's operating margins allowance should include any financing costs incurred. However, concerns were expressed as to how financing costs would be recovered in the long term and in particular whether balancing neutrality costs would be incorporated in the SO Commodity Charge. The respondent also stated that it assumed that any allowance for financing costs should be subject to an economic purchase obligation.

The other respondent to this modification did not support its implementation. It felt that the funding of OM gas through the network code was already established, and that the separate identification of financing costs would reduce Transco's exposure to these costs and its incentives to keep them to a minimum.

Transco's view

Transco states that the financing costs of OM gas are excluded from the existing network code funding arrangements. Transco states that the costs of financing OM gas amount to approximately £750k to £1m per annum. Transco states that the proposal is consistent with the requirement under the Gas Act that it be allowed sufficient funding to finance its activities in operating the gas transmission system. Transco also states that the proposal better facilitates the efficient discharge of its licence obligations as these obligations provide that it should secure sufficient financial facilities to enable it to carry on its transportation business.

Ofgem's view

Ofgem is mindful of its duties under Section 4AA(2)(b) of the Gas Act 1986 (as amended by the Utilities Act 2000) that in carrying out its objectives it shall have regard to the need to secure that licence holders are able to finance their activities. Ofgem also recognises that Special Condition 3(1) of Transco's GT licence requires the licensee to secure sufficient financial resources to carry on its transportation and LNG storage business. However, in this instance, Ofgem does not consider that Transco's proposal would better facilitate the efficient discharge of special condition 3(1).

In this respect, Ofgem considers that Transco has already been provided with previous price control based funding for the costs of the current stocks of OM gas. Further, on the basis of data obtained from Transco by Ofgem, we are not satisfied that Transco has purchased any significant quantities of additional OM gas since December 1996. As such, it follows that Transco has not incurred any additional financing costs from those that have already been funded.

Ofgem notes that Transco's stock of OM gas at LNG facilities has increased in the period since December 1996. In particular, data provided to Ofgem by Transco indicates that this has happened on several occasions between December 1996 and April 2002. However, Transco's overall level of OM stocks at all storage facilities does not appear to have increased during this period as changes in OM LNG stocks tend to have been matched or exceeded by corresponding withdrawals at the Rough storage facility. Indeed, Ofgem would note that Transco has actually reduced its OM stocks to reflect lower OM requirements.

Ofgem's decision

Ofgem has decided to direct Transco not to implement this modification because we do not believe that it better facilitates the relevant objectives in Transco's Gas Transporters licence. In particular, for the reasons outlined above Ofgem does not consider that the proposal would better facilitate the efficient discharge of Transco's obligations under its 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 Amrik Bal on extension 7074.

Yours sincerely,

Mark Feather
Head of New Gas Trading Arrangements