

Direct Dial: 020-7901 7437
Our Ref: Net/Cod/Mod/520

27 September 2002

Transco, Shippers and Other Interested Parties

Dear Colleague,

Modification Proposal 0520 *'Removal of Entry Capacity Incentives from the Network Code'*

Ofgem has considered the issues raised in Modification Proposal 0520 *'Removal of Entry Capacity Incentives from the Network Code'*. Ofgem has decided to direct Transco to implement the modification because Ofgem considers that this proposal will better facilitate the relevant objectives of the Network Code.

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 plc ('Transco') has offered firm monthly system entry capacity (MSEC) rights to its National Transmission System (NTS) for sale via six-monthly auctions since September 1999. In addition to offering MSEC, Transco also releases firm and interruptible capacity on a daily basis where there is additional capacity available.

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 buy back the capacity until the constraint is relieved. Transco has financial incentives within its Network Code to efficiently manage the costs of buying back capacity it has sold but cannot make physically available.

Transco's entry capacity incentives

Transco's entry capacity incentives are designed to encourage it to manage buy-back costs and release all physically available entry capacity to market by selling additional capacity on the day. Transco may need to buy back capacity for a number of reasons such as, its maintenance programme, seasonal effects or plant reliability.

Modification Proposal 0488 '*Redesign of Capacity Incentive Regime*' which was accepted by Ofgem in August 2001 introduced an entry capacity incentive based on a sliding scale design for the period 1 October 2001 to 31 March 2002. Under this incentive Transco was set an ex ante agreed target level of entry capacity buy-back costs and incremental revenues. Transco's rewards and costs arising under this incentive are determined on the basis of a comparison of the net cost (revenue) of actual capacity buy-back costs and incremental sales revenue (the Capacity Incentive Performance Measure (CIPM)) with the ex ante agreed target level. Under that modification when CIPM is equal to zero (ie, actual costs are equal to forecast), Transco faces no reward or penalty. Transco obtains rewards (penalties) when actual costs are lower (higher) than forecast in accordance with sharing factors, up to a maximum reward (risk) cap and collar.

Following Ofgem's acceptance of modification proposal 0540, '*Delay of Licence and Effects on Capacity Incentives*' on 28 March 2002, new parameters were introduced to Transco's buy-back incentive with effect from 1 April 2002 to 31 March 2003. These parameters included an annual target of £35 million and a cap of £30 million for superior performance and a collar of £12.5 million for performance below target.

The costs of entry capacity buy-backs and the revenues from incremental sales of capacity are distributed via capacity neutrality arrangements contained within the Network Code. Under these arrangements, the costs of buy-backs are recovered from shippers according to their national end of day firm entry capacity holdings. The net payments and costs arising from Transco's performance under its buy-back incentive are recovered from shippers via Transco's SO commodity charge.

Transco System Operator Incentives proposals

Ofgem published its final proposals for Transco's NTS System Operator (SO) incentives for 2002-7 in December 2001.¹

¹ '*Transco's National Transmission System Operator Incentives – Final proposals*', Ofgem, December 2001.

On 12 April 2002, the Authority issued a notice ('the Original Notice') under section 23 of the Gas Act 1986 ('the Act') to modify the Gas Transporter (GT) licence of Transco. The modifications concerned Transco's transmission asset owner ('TO') price control, its system operator ('SO') incentives, and its metering activities for the period to April 2007. The modifications also concerned the disclosure of Transco SO information and the ability of third parties to raise modifications to Transco's Network Code. The Original Notice was accompanied by an explanatory document ('the Explanatory Note') that was also issued on 12 April 2002.²

Following careful consideration of the responses that were received to the 12 April Original Notice, Ofgem identified and logged a number of drafting changes to the proposed licence modifications as originally consulted on. During the consultation several respondents suggested that if the Authority decided to make changes to the proposed modifications, there should be a further consultation. The Authority considered this and concluded that the changes identified fell within its powers under section 23 of the Act and the terms of the Original Notice and as such the Authority had the power to direct that the modification be made. However, the Authority considered that, in recognition of concerns expressed by respondents, there should be a further limited consultation on this occasion.

Against this background, on 1 August 2002, the Authority issued a further section 23 notice ('the Second Notice') in respect of Part A only of the proposed modifications to Transco's GT licence. This Second Notice was accompanied by a log³ of the proposed changes ('the Log') that were made to the proposed licence modifications attached to the Original Notice. The closing date for responses to the Second Notice was 30 August 2002. The Second Notice was also accompanied by an open letter to industry. Each of these documents is available on Ofgem's website.

The Authority has now carefully considered the responses to each section 23 notice and has identified a number of further minor changes to the drafting in respect of Part A of the Second Notice and in respect of Part B.

² *Transco price control and NTS SO incentives 2002-7, Explanatory notes to accompany the section 23 notice of proposed modification to Transco's gas transporter licence*, Ofgem, April 2002.

³ *'Log of changes to the proposed licence modifications'*, Ofgem, August 2002

The Authority has concluded that the licence modification proposals as amended by the changes that have been identified in response to the Second Notice fall within section 23 of the Act. In particular, Ofgem considers that no further consultation is necessary as the further changes fall within the Authority's powers to make incidental and consequential modifications under section 23. The changes that have been identified are consistent with the Original Notice, the Second Notice, the Explanatory Note and the Log. A second log of changes ('the Second Log') has been prepared setting out the modifications made to the licence modification proposals as consulted on in the Second Notice. The Second Log is available from the Ofgem website.

On 26 September 2002, Transco gave its written consent to the modifications as amended (in the form of the direction) and the Authority has received confirmation from the Department of Trade and Industry that the Secretary of State does not intend to exercise her power of veto under the Act with respect to the proposed modifications.

In this context Ofgem has therefore today issued a direction ('the Direction Notice') to implement the proposed modifications to Transco's GT licence with effect from today (27 September 2002). In accordance with Ofgem's press statement dated 22 February 2002, the Direction Notice and the associated modifications have retrospective effect from the date of introduction and shall apply on and from 1 April 2002. A copy of the Direction Notice and associated licence modifications is available on the Ofgem website.

The proposal

The proposal would remove the entry capacity incentive scheme provisions from the Network Code and migrate the entry capacity neutrality provisions from the transitional document to the substantive body of the Network Code

Respondents' views

Most respondents did not support the proposal. Some respondents gave qualified support.

Most respondents that did not support the proposal were concerned that removing the incentive from the Network Code would remove shippers' ability to effect

changes to the regime. Many respondents expressed the view that the incentives impacted financially not only upon Transco but also upon shippers. As such, they were of the view that shippers should be able to propose changes to the regime in future.

One respondent indicated that if the parameters of the incentive regime go into Transco's licence it would be impossible for shippers to make changes if, for example, the incentives were set too far in Transco's favour.

One respondent added that the modification would reposition Ofgem's role in the contractual arrangements between shippers and Transco and at the same time undermine the position of shippers. It did not believe that this would improve the efficient operation of the pipeline system and argued that recent experience with the buy-back incentive did not give confidence that Ofgem is always able to accurately forecast Transco's likely buy-back requirements.

Some respondents that did not support the proposal also stated that the modification proposal was premature because shippers had not had the opportunity to see and make comments on the proposed licence modification proposals. Two respondents qualified their support of the proposal because they felt that the consultation on the removal of incentives from the Network Code should have been concurrent with debate on the proposed licence modifications.

One of these respondents recognised the merits of placing the incentive regime in Transco's licence but felt that it should only reside in the licence when there is greater certainty about the regime structure and the interaction of the incentives. This respondent indicated that previous experience had suggested that there is often a need to amend Transco's incentives and that they should continue to reside in the Code until more confidence is gained regarding the incentive regime.

One respondent supported the proposal, viewing it as an essential part of implementing the new SO incentives by ensuring consistency between Transco's GT licence and the Network Code. This respondent supported placing as many elements of the incentives in Transco's licence to reduce the level of regulatory uncertainty.

Transco's view

Transco believes that this modification is required to facilitate the implementation of Ofgem's proposals to revise the structure of Transco's NTS SO incentives as under these proposals the definition of Transco's incentives (including the capacity buyback incentives under consideration here), the incentive parameters and provisions for the calculation of incentive amounts will be contained in Transco's GT licence.

Transco states that this proposal would facilitate adherence to the objective of the efficient discharge of Transco's GT licence obligations. Transco also stated that an advantage of the proposal is to facilitate an 'appropriate governance structure and a stable regulatory regime within which Transco may respond to its incentives'.

Transco states that shippers will still be at liberty to make informal representations to Ofgem if they believe that it would be in the interests of the industry and consumers for Transco's incentives to be modified.

Further consultation

In August 2002, Transco conducted a further consultation on this modification proposal pursuant to the Network Code Modification Rules. A small number of responses were received to this additional consultation.

Respondents' views

One respondent stated that whilst holding the incentives in the licence may provide greater stability for Transco, it nevertheless believed that the benefits afforded by this stability were outweighed by the reduction in flexibility and the ability of shippers to work with Transco develop the incentive regime. The respondent proposed that a small expert group be established to evaluate interactions between the Network Code and the licensing regime.

Another respondent reiterated its view that the incentives belong in the Network Code. A further respondent indicated that if Ofgem directs its proposed licence modifications then the incentive structure within the Network Code becomes redundant and, if not, there is a need for the incentive regime to remain in the Network Code.

Transco's views

In its supplemental report Transco indicates that conditional upon modification proposal 0500, '*Long term capacity allocation*' being implemented, it does not now believe that this proposal should be implemented. In particular Transco states that if implemented, the legal text for modification proposal 0500 would achieve the objectives set out in this modification proposal.

Ofgem's view

As outlined above, Ofgem has today issued a Direction Notice to implement the proposed modifications to Transco's GT licence with retrospective effect from 1 April 2002. Amongst other things, these licence modification proposals introduce a new entry capacity buy-back incentive into Transco's licence with the same parameters of the buy-back incentive that is contained within the Network Code and which forms the subject of this modification proposal.

In view of this development Ofgem considers that the removal of Transco's Network Code capacity incentive would better facilitate the efficient discharge of Transco's GT licence obligations as they presently exist. In particular, Ofgem considers that it is inappropriate for Transco to be subject to both a Network Code and a GT licence incentive going forward.

Ofgem notes that a number of respondents have raised concerns regarding the removal of the incentives from Transco's Network Code into Transco's GT licence. As we have outlined in our open letter to the industry issued today accompanying the direction to modify Transco's GT licence, Ofgem considers that it is important that those elements of the incentive regime (including its entry capacity buy-back incentive) that have a potentially material impact upon Transco's financial position should be included within its GT licence.

Further, Ofgem considers that it is important to provide Transco with a sufficient degree of certainty in order to allow it to fully respond to its incentives. The stability offered by inclusion of the incentives regime in the GT licence should provide that certainty. The removal of the incentives regime from Transco's Network Code should also provide the stability that some shippers have asked for.

Ofgem also considers that the inclusion of the incentives in the licence is consistent with the governance of NGC's incentive regimes. Consistency in the governance of both Transco and NGC's SO incentives is important given the increasing interactions between the two markets.

The licence modifications envisage regular reviews of the SO incentives including the review of various elements of the SO incentive package from 1 April 2004. All parties will have the opportunity to be involved in these reviews. In addition, shippers will also have the opportunity to informally raise with Ofgem any concerns regarding the operation of the incentives.

As an additional point, shippers also have the ability to request that the Authority directs Transco to undertake a review of its System Management Principles Statement in the event that shippers have concerns regarding the manner in which it is deploying its various system management tools under its SO incentives.

Ofgem notes Transco's revised view with respect to this proposal and the effect of the legal text contained within modification proposal 0500. Ofgem has not however reached a decision on modification proposal 0500. A decision on this proposal will be issued shortly. Ofgem therefore believes that it is appropriate to implement modification proposal 0520 for the reasons outlined above.

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 Amended 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 Lyn Camilleri on 020 7901 7431.

Yours sincerely,

Mark Feather
Head of New Gas Trading Arrangements