

OFGEM DECISION LETTER No. OG25
"Facilitation of Capacity Management Arrangements"
Version 1.0

Transco, Shippers and Other Interested Parties

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Dear Colleague,

Modification Proposal OG25: Facilitation of Capacity Management Arrangements

Ofgem has considered the issues raised in Modification Proposal OG25 *'Facilitation of Capacity Management Arrangements'*.

Transco raised this proposal on 8 March 2002. Ofgem received the final modification report on 26 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 notes that some respondents have raised concerns regarding the delay to the release of proposed modifications to Transco's Gas Transporter's (GT) licence to introduce Transco's price control for the period April 2002-7 in accordance with the statutory consultation process set out in section 23 of the Gas Act 1986. One respondent has indicated that it is difficult to comment on the proposed modification before having had the opportunity to review and respond to the proposed modifications to the GT licence.

In this context, Ofgem wishes to clarify the basis upon which it has assessed this modification proposal.

Any decision placed before the Authority under special condition 17 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 shortly. Ofgem regrets that the licence modification proposals have not yet been

consulted upon. However the translation of the SO Final Proposals into licence changes has been a substantial undertaking.

The basis for considering whether to direct that this modification be made is set out in special condition 17 of Transco's GT licence. Having regard to the criteria set out there and for the reasons set out in the Ofgem's views section of this letter, Ofgem has decided not to veto this modification proposal as we believe that it is consistent with the relevant objectives.

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

Background to the proposal

Under the capacity arrangements set out in Transco's network code, Transco buys back National Transmission System (NTS) entry capacity that it has sold but cannot physically accommodate on the day.

Transco currently has financial incentives that are designed to ensure that Transco efficiently manages the costs of any buy-backs by exposing it to a proportion of any buy-back costs incurred. The incentives are also designed to ensure that it releases all physically available entry capacity to market by selling additional capacity within-day.

On 28 March 2002, Ofgem accepted modification proposal 0540, '*Delay of licence and effects on capacity incentives*' to implement a revised capacity incentive from 1 April 2002. Under the 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. Under the incentive Transco has been set an annual target of £35 million. The incentive is subject to an annual cap of £30 million and a collar of £12.5 million and includes a 50% upside sharing factor and a 35% downside sharing factor.

In several documents Ofgem has indicated that Ofgem that Transco should develop a wider range of tools to manage entry capacity buy-backs to increase the efficiency by which it operates the NTS. See '*Ofgem's investigation into shipper conduct in the capacity market in October 2000*, Conclusions, November 2001; *Transco's National Transmission System – System Operator incentives 2002-7*, Initial proposals, September 2001; *Transco's National Transmission System system operator incentives 2002-7*, Final proposals, December 2001. This would reduce the reliance on the daily market where Transco may often be a distressed buyer. The development of other tools would better enable Transco to manage its and shippers risks and costs associated with entry capacity buy-backs. In this context Transco raised network code modification proposal 0498, '*Capacity forward and option entry capacity management*'. This proposal which was approved today, enables Transco to use a wider range of tools designed to facilitate the opportunity to mitigate buy back exposure and potentially enter into forwards and options contracts for the purposes of entry capacity constraint management.

Transco considers that the implementation of this modification would require a change to the Operational Guidelines in order to enable new tools to be procured and utilised for entry capacity constraint management purposes. In this context Transco has raised OG25.

The Modification proposal

The proposal is intended to inform shippers of the broad framework that Transco is proposing to employ in respect of the procurement and deployment of capacity management agreements as envisaged under Network Code modification proposal 0498 that was implemented today.

The proposal is intended to inform shippers of the capacity management tools that Transco may utilise. The proposal describes the nature of these tools (eg forwards, options and futures contracts). The proposal describes in broad terms the circumstances in which these tools will be procured and used (eg to reduce the costs of capacity management). The proposal also provides for changes to the Operational Guidelines hierarchies to accommodate the use of tools that it may acquire as a result of the implementation of Network Code modification 0498.

Respondents' views

Three representations were received. One respondent did not support the change, and two did not express a definite position.

The shipper opposing the proposal noted that any changes to the current regime should await the consideration of the proposed GT licence changes and the development of the Procurement Guidelines and System Management Principles Statement. While the shipper supports the broad concepts in network code modification 0498 and OG25, it considered that it would be better to implement the more flexible capacity management tools from 1 October 2002. This shipper raised concerns regarding the delay to the publication of the Transco's GT licence modification proposals and indicated that the delay has affected the ability of Transco and other interested parties to develop the other documents related to capacity constraint management such as the Procurement Guidelines and System Management Principles Statement.

The other respondents expressed similar concerns regarding the proposed licence amendments and associated documents. These respondents also raised general concerns about the coverage of the current FSA exemption, the design of the products, charging implications and the method of procurement. One respondent indicated that the tender process is key and should be an open process. This respondent also indicated that there should be no requirement for a shipper to own capacity at the time of the tender. Another shipper commented that there is no detail available about the amount and type of information that will be available to tender participants and to the wider market before and after the tendering process.

There were several comments made specifically in relation to OG25. One respondent referred to the fact that Transco has changed the hierarchies for dealing with a localised input capacity constraint such that it now proposes that it will aim to maximise system entry capability through adjustments to the physical strategy. The respondent commented that Transco should maximise system entry capacity not just 'aim' to do this. Previously, adjustments to the physical strategy formed part of the hierarchy steps.

One shipper expressed concern about Transco's use of Transportation Flow Advices (TFAs), asking how Transco determines when to issue a TFA. It also considered that the definition of system entry capability implied a 1/24th flow rate without detailed discussion with the industry.

Transco's view

Transco notes that it was an intent of the SO proposals that Transco should have greater facility to develop and deploy a much wider range of tools to manage risks arising from the new

capacity regime particularly in circumstances where it was envisaged that Transco's entry capacity incentive exposure would be increased from 1 April 2002.

Transco indicated that it believed it essential that a framework is in place from 1 April 2002 or soon after to improve its ability to manage the financial risks associated with its entry capacity incentives.

Transco commented that the details of contract design and tender processes would be contained within any tender that it may issue. Transco has indicated that any tender process should be widely advertised and open to all shippers.

Transco commented that a TFA will only be used when a pressure trigger is breached or anticipated to be breached. Transco states that this would occur because, following commercial constraint management actions, flows remain at levels in excess of commercially available capacity or insufficient commercial constraint management actions are available. Transco notes that the general arrangements for issuing TFAs have been discussed in various workstream meetings and operational forums.

In respect of the definition of system entry capacity, Transco note that capacity release and management has been conducted in this manner ever since the introduction of the within day market.

Transco also indicated that it envisages that the interim arrangements it has proposed will remain in place until any licence changes are finalised and the Procurement Guidelines and System Management Principle Statement are implemented.

Ofgem's view

Ofgem notes the concerns of shippers with regard to the details of the proposed changes to Transco's GT licence and the associated documents dealing with system management and procurement guidelines. However, consideration of this modification proposal is not dependent upon the publication or acceptance of the proposed licence changes or indeed the preparation or approval of the proposed Procurement Guidelines document or System Management Principles Statement.

Instead Ofgem has considered this modification proposal and the responses from shippers against the background of the current licence regime and regulatory arrangements that currently exist governing Transco's management of entry capacity constraints. Within this framework Ofgem considers that it is consistent with Transco's relevant objectives for Transco to set out the framework by which it intends to procure and utilise forward and options contracts to manage the costs associated with entry capacity constraints. Moreover, Ofgem considers that the criteria adopted by Transco for determining when to utilise a capacity management agreement, such as to reduce the costs of capacity management, are consistent with the objective of the efficient and economic operation of the NTS.

Ofgem also notes that Transco has adjusted its localised constraint management processes to specify that it will aim to maximise system entry capability through adjustments to the physical strategy. Previously, the Operational Guidelines indicated that Transco would adjust the physical strategy first by employing compression to reduce NTS upstream pressures and then, where possible by varying NTS offtake profile rates for limited periods. Ofgem considers that

this change is consistent with the flexibility provided by Transco's commercial incentive framework and should allow for more efficient system management.

Ofgem's decision

Ofgem has decided not to veto this modification proposal as we believe that it is consistent with the relevant objectives for the reasons outlined above.

If you have any queries in relation to the issues raised in this letter, please feel free to contact me on the above number. Alternatively you may wish to contact Adam Cooper on extension 7033.

Yours sincerely,

Mark Feather
Head of New Gas Trading Arrangements