# TRANSCO NETWORK CODE MODIFICATION PROPOSAL No. 0488

"Redesign of Capacity Incentive Regime"
Version 1.0

**Date:** 15/08/2001

**Proposed Implementation Date:** 01/10/2001

**Urgency:** Urgent

## Justification

Urgent status is requested for this Modification Proposal to enable simultaneous implementation of this Proposal and Modification Proposal 0481, the latter Proposal came into effect on 06:00 13 August 2001.

Transco's current capacity incentive rewards Transco for release of additional capacity and penalises it for capacity buybacks. It is designed to give a risk/reward profile, with an annual receipt/payment limit of +/-£5m and a monthly receipt/payment limit of £416k (1/12th of £5m). Transco's risk exposure (and reward opportunity) is defined by a "20:80" split between Transco and shippers; this allows Transco to retain 20% of the revenues from net release of additional capacity and 20% of the costs from net capacity buybacks, subject to the caps and collars.

Ofgem directed Transco to implement Modification Proposal 0481 that will ensure that increased system entry capacity volumes are released for MSEC auction. This proposal is likely to remove any significant opportunity to raise revenue through the release of additional capacity, but will increase the likelihood of capacity buybacks. Consequently, Transco's current incentive is likely to have no upside whilst the risk on the downside will increase significantly. This is contrary to the principle of a symmetric incentive based on risk and reward, and would represent a material change to the present incentive. The prospect of reaching each monthly collar is also increased, potentially negating Transco's direct financial incentive to operate the buyback mechanism at the lowest possible cost.

In its decision letter of 9 August 2001 on Modification Proposal 0481, Ofgem states that "as the proportion of capacity to be sold in the monthly auctions affects the risks and rewards under Transco's incentive scheme, this has been a source of some concern to Ofgem". Ofgem also states that it "accepts that a release based on maximum physical capacity may increase the probability of buyback actions if the network is constrained this winter". Transco shares Ofgem's concerns and agrees that, as a consequence of Modification Proposal 0481, "adjustment to Transco's capacity incentive may be appropriate".

## Nature of Proposal

The proposal is to separate current capacity neutrality from the capacity incentive and calculate and invoice for each separately.
The capacity buyback costs and any incremental sales revenue will continue to be redistributed via current capacity neutrality arrangements. However, the current capacity incentive will be

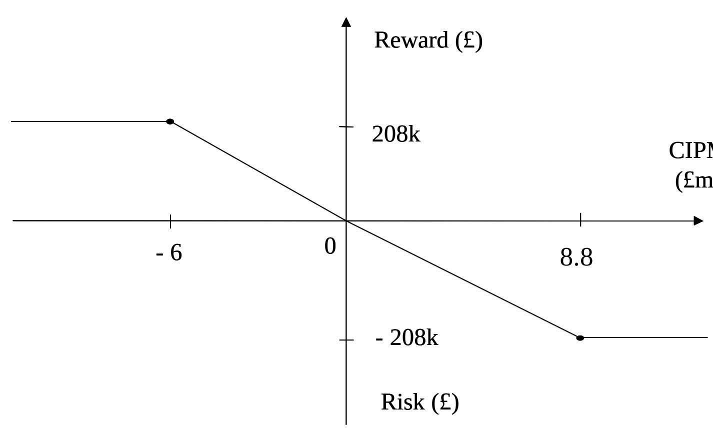
disabled. This results in 100% of the capacity buyback costs and 100% of incremental sales revenue accruing to Shippers.

A new incentive will be introduced under which Transco's Capacity Incentive Performance Measure (CIPM) is the magnitude of the net cost, or revenue, of actual costs of capacity buy backs and incremental sales revenue for a month compared to an ex-ante forecast of the same. Where CIPM is equal to zero (i.e. actual net costs are equal to forecast) Transco will face no reward or penalty. Superior performance occurs when actual costs are lower than the forecast and inferior performance occurs when actual costs exceed those forecast.

The level of forecast costs is expected to be a function of the physical capability of the system, the cost of buy backs, revenue from incremental sales, supply pattern preference and the level of firm capacity sold. Based on its analysis of buy back costs and incremental sales Transco suggests that for the expected value of CIPM to equal zero, forecast costs should be set at £10m per month over the six month period commencing on 1 October 2001; representing one sixth of the forecast mean costs over the six months.

To mitigate the significantly greater uncertainty associated with buy back costs resulting from Modification Proposal 0481, Transco proposes that its maximum potential risk and reward be reduced to half their present values, leading to a cap and collar of +/- £208k per month. This would limit the potential financial impact on both shippers and Transco arising from the increased uncertainty present within the revised regime.

Transco's analysis indicates a 90% confidence interval for forecast costs of £24m to £113m over the forthcoming six month capacity period. Transco proposes that under the new incentive, the monthly cap and collar would be set consistent with this confidence interval, and hence be one sixth of the lower and upper ends of this range respectively. This would ensure that Transco continued to have a direct financial incentive to minimise buyback costs, and maximise revenue from capacity sales, over a wide range of scenarios. Transco's share of any cost or reward would be calculated based on linear interpolation from the mid point (£10m per month) to the cap or collar respectively.




Performance Measure = Actual Cost – Forecast Cost

The proposed apportionment methodology will be the same for distributing both the revenues and costs arising from the new capacity incentive. The apportionment methodology of capacity incentive revenues and costs will be in proportion to the sum of each shippers MSEC capacity holdings across all ASEPs for that month, divided by the sum of all MSEC capacity holdings for all Users across all ASEPs for that month which is consistent with the current method of sharing daily capacity costs.

It is intended for this revision to the capacity incentive to exist to cover the period 1 October 2001 to 30 March 2002 .

**Purpose of Proposal**

Transco's current capacity incentive rewards Transco for release of additional capacity and penalises it for capacity buybacks. The risk/reward profile for the current incentive is based on the principle of symmetry.

Implementation of Modification Proposal 0481 is likely to bias the outcome towards capacity buybacks. Consequently, Transco expects not only to have no upside under the current incentive but to be exposed to increased risk.

The proposal seeks to rebalance the risk/reward distortion resulting from Modification Proposal 0481, and to maintain the principle of symmetry between risk and reward.

Transco believes that a financial incentive linked to costs will continue to directly incentivise Transco to operate the short term capacity mechanisms efficiently. This will facilitate the "efficient and economic operation by the licensee of its pipeline system", as stated in the Standard Condition 7 of its PGT licence.

**Consequence of not making this change**

The risk/reward profile in the current capacity incentive will effectively turn into a liability without any likelihood of a reward. This is contrary to the principle of an incentive based on risk and reward and would represent a material change to the existing incentive.

**Area of Network Code Concerned**
Transition Document
Section B System Use and Capacity;
Subsection 2.13: Incentive and neutrality arrangements

**Proposer's Representative**

Nigel Sisman (Transco)

**Proposer**

Tim Davis (Transco)

## Signature

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