

Direct Dial: 020-7901-7437

25 May 2001

Transco, Shippers and other Interested Parties

Our Ref: net/cod/mod/0451

Dear Colleague,

Modification 451 “Treatment of Constrained Top Up Costs for Storage Year 2001/02”

Ofgem has considered the issues raised in modification proposal 451 *‘Treatment of Constrained Top Up Costs for Storage Year 2001/02’* and has decided to direct Transco to implement the modification because we believe that it better facilitates the relevant objectives of Transco’s network code.

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

Background

Under Standard Condition 13(1) of its PGT licence, Transco is obliged to plan and develop its pipeline system to meet certain security standards. The standard is that its pipeline system can meet the peak aggregate daily demand that is only likely to be exceeded once in every 20 years taking into account weather derived from at least the previous fifty years. This is Transco’s 1 in 20 requirement.

Transco meets these requirements through a number of measures, including investment in pipelines, the use of interruptible transportation terms and the use of gas storage facilities. In using gas storage facilities, Transco sets an opening monitor level at its five Liquefied Natural Gas (LNG) sites. These monitor levels represent Transco’s estimate of the volume of gas in store needed at different times of the year to ensure that the security standards can be met. Any shortfall between this monitor level and total shipper bookings is made up by Transco (acting as what

is known as the Top-up Manager) purchasing 'top-up' gas, the costs of which are recovered from shippers. At three of the sites, Isle of Grain, Avonmouth and Dynevor Arms, Transco will constrain shippers' use of gas in exchange for reduced transportation, i.e. exit capacity, charges. This is so that Transco might use such gas for transmission support purposes. Any top-up purchase made by the Top-up Manager at these sites is known as Constrained LNG Top-up (CLNG Top-up).

In April 1998, Ofgas confirmed that in its view top-up would not be needed in the long term given the increase in the availability and diversity of peak gas supply sources¹. In the context of envisaged reform of the storage market and a new energy balancing regime, which would incentivise shippers to make adequate provision for their peak day needs, Ofgas argued that top-up could be removed from Transco's network code. Given that the provision of top-up formed part of its existing Safety Case, Transco would also have to re-submit its plans for the removal of top-up to the Health and Safety Executive (HSE) for approval.

Progress on removing top-up from the network code was not as rapid as the shippers expected. Consequently, BGT proposed modification 237 '*Top-up cost treatment*' which, had it been accepted, would have seen Transco bear the full cost of any top-up which it purchased. Ofgas rejected modification 237 (in November 1998) on the basis that under the proposal Transco could have received revenues well in excess of the costs it had incurred in providing top-up, if top-up had been used. This decision, however, coincided with the ongoing review by Ofgas of the supply of storage and related services². This review identified the top-up regime as being a key obstacle to the development of competition in the storage market. Furthermore, the ability of Transco to recover the cost of top-up through smearing was found to distort purchases of storage capacity.

The storage review also concluded that the regulation of LNG storage services would not be amended at that time but should instead be subject to a further review in 1999. Consequently, the storage market was only partially deregulated in February 1999 when auctions of capacity at BG's Rough and Hornsea storage facilities took place. At the same time, a new price control was introduced for the remaining LNG facilities. The new price control replaced the existing maximum revenue cap on all

¹ Review of top-up gas. Conclusions, Ofgas April 1998.

² Review of the supply of gas storage and related services, the Director General's initial proposals. July 1998.

storage services with a specific maximum price cap applying to each of the LNG sites.

In February 1999, BG plc also gave Ofgas a series of Undertakings. In part, BG plc was now obliged to undertake discussions with the HSE regarding the removal of top-up from BG's Safety Case³. The expectation was that top-up would be removed before the storage year 1999/00 commenced. In the meantime, however, Ofgas approved BGT's modification proposal 297 - 'Top-up Cost treatment'. This proposal sought to prevent Transco recovering the costs of top-up gas from shippers, and was implemented on 26th February 1999.

In the summer of 1999, Transco did re-submit its Safety Case but decided to do so more as a consequence of the Reform of Gas Trading Arrangements (RGTA) than any top-up consideration. Notwithstanding this point, Transco did include the removal of top-up requirements in its re-submission of its Safety Case to the HSE.

In June 1999, Ofgem launched its review of LNG storage services⁴. In the review, Ofgem noted that at the current prices being charged by BG, there appeared to be a significant amount of unutilised storage capacity. Ofgem also noted that BG Storage had not proposed lowering prices to stimulate greater capacity utilisation. Special Condition 9D - which specifies the maximum LNG capacity charges at each site - provides for the licensee to seek a derogation enabling LNG capacity prices to be reduced. Transco made clear that it would propose a network code modification that would enable it to recover the costs of an efficient level of constraint top-up. In response, Ofgem stated that in considering any proposal it would "look for evidence that all top-up purchases are efficient (including consideration that LNG may be overpriced by BG plc and that the costs of top-up are only an internal transfer within BG plc)."

In the storage year 1999/2000 Transco purchased CLNG Top-up at the Avonmouth and Dynevor Arms facilities. Transco then brought forward Network Code modification 0356 '*Treatment of Constrained LNG Top-up costs*' to recover the associated costs retrospectively. Ofgem rejected the modification because we did not believe that the proposal better facilitated the relevant objectives.

³ See Ofgas' "Review of the supply of gas storage and related services, a Decision Document", February 1999.

⁴ Review of BG plc's Liquefied Natural Gas Storage Facilities: A consultation document", Ofgem, June 1999.

In the interval between modification 297 being accepted and the LNG Annual Storage Tender for 1999/2000, there was sufficient time for Transco to seek a derogation to lower the LNG capacity charges or increase the transportation rebates offered to LNG storage capacity holders at the constrained sites. Either course of action would have lowered the effective price of LNG capacity, increased shipper bookings and reduced the need for Transco to book LNG capacity. Either approach, or a combination of the two, would in Ofgem's view, have resulted in shipper bookings in excess of the monitor levels and as a result Transco would not have been required to make any CLNG bookings. This would have resulted in a zero cost to Transco of CLNG Top-Up requirements. As a result, Ofgem judged that the costs that Transco was seeking to recover had not been efficiently incurred and rejected the modification. Ofgem also expressed concern about the retrospective nature of the proposal.

In March 2000 Transco raised modification 391 '*Treatment of Constrained Top-up for 2000/02*'. This proposed that the costs of Constrained Top up (but not National Top-up, i.e. at the two unconstrained sites) for the period 2000/02 should be recovered from shippers through the Top up Neutrality mechanism.

Ofgem approved modification 391 but for the storage year 2000/1 only. Our decision for a one-year approval was based on the view that longer-term LNG arrangements would be considered as part of Ofgem's review of exit capacity, interruptions and LNG arrangements. Any subsequent changes to the LNG arrangements that resulted from this review were planned to have been applicable from 2001 onwards. Modification 391 allowed Transco to recover the net cost of CLNG Top-Up, that is the LNG capacity cost plus commodity and gas costs less any revenues accruing to the Top-Up Manager account. These revenues include those from the sale of gas and the transportation rebate payable to shippers. The level of rebates was the subject of Transco's pricing consultation PC52 '*Transportation rebates at constrained LNG*'.

Ofgem published its consultation document on exit capacity, interruptions and LNG Arrangements in March 2001. Given that Transco LNG had already issued its annual storage invitation in respect of the storage year 2001/02, Ofgem concluded that there was obviously insufficient time to implement any significant changes to LNG arrangements prior to this year's LNG auctions.

Transco has thus proposed modification 451 to continue the cost recovery arrangements established through modification 391 for a further year.

Proposal

Transco proposes to continue the cost recovery arrangements established through modification 391 for a further year starting from 1st May 2001.

There will be no requirement for network code modifications to allow LNG capacity to be sold using a continuation of modification proposal 0391 provisions, but Transco will require a further derogation to deviate from the fixed LNG prices required by Special Condition 9D of its PGT licence.

Respondents' views

Five responses were received. The majority of respondents supported modification 451 as the most practical means of continuing the interim arrangements instigated by modification 391 for a further year, pending any longer term arrangements that result from Ofgem's forthcoming consultation on exit capacity, interruptions and LNG arrangements. One of these respondents commented that it supported the modification provided that Ofgem would "closely monitor Transco's actions to ensure that any costs are efficiently incurred".

One respondent did not support the modification. It had expressed similar reasons for not supporting modification proposals 356 and 391. The respondent believed that Transco should bear the costs of constraints / Top up bookings, and referred to Ofgas's 1998 Review of Top Up, in which Ofgas stated that Transco should bear the costs of LNG transportation costs. The respondent also argued that under modification 451, cost recovery will remain unfocussed, and would not target those shippers who failed to make adequate peak gas provision, and thus contribute to local transmission constraints by not booking constrained LNG. Furthermore, the respondent believed Transco has no incentive to optimise Top up costs or capital expenditure under the proposal.

The respondent expressed disappointment that no consideration had been given to the sharing of costs between Transco and shippers, or a redistribution of costs between shippers, during the year since modification 391 was accepted. However, the respondent expressed a view that if LNG auction arrangements remain largely the same as in 2000/1, it is likely that no CLNG Top-up bookings will be required.

Transco's views:

Transco believes that if cost recovery is not allowed, it will have an incentive to invest in pipeline capacity rather than use existing LNG assets, which would contradict its license obligation to be efficient and economic in its operation of its pipeline system. Transco believes that extending these arrangements for another year will provide a reasonable period of time to consider changes to the LNG arrangements.

With regards to the comments made by the respondent who opposed the proposal, Transco has the following views:

It believes that Ofgas's earlier comments reflected its view on 'National' rather than Constrained Top-up. It acknowledges that focussing on National Top up costs remains an issue, but suggests that no viable solutions have been found. With regards to sharing Constrained Top up costs with shippers, Transco does not believe that this would be appropriate, arguing that this would forgo the advantages of the modification proposal. It argues that the cost focussing issue is not relevant to Constrained Top-up.

Transco agrees that if the arrangements for selling LNG capacity are largely similar to last year, it is probable that no CLNG Top-up bookings will occur.

Ofgem's views

In deciding whether to accept a modification to Transco's Network Code, Ofgem must decide whether the modification "better facilitates the relevant objectives" as given in Standard Condition 7 paragraph 1 of the Gas Transporters' licence. Of the relevant objectives, the most relevant is 7(1)(a). This relates to efficient and economic operation by the licensee of its pipeline system.

Transco only purchases CLNG capacity for Top-Up purposes if shipper bookings are below the opening monitor levels. For the storage year 2000/1 shipper bookings were made through pay-as-bid auctions, with higher transportation rebates

available at the constrained sites⁵. The 2000 auctions resulted in sufficient shipper bookings, so no CLNG bookings were needed in 2000/01.

One of the key objectives of the LNG auctions is to ensure that all LNG storage capacity is made available to the market on a non-discriminatory basis. If there is sufficient shipper demand, then the monitor levels should be exceeded at each of the constrained sites and Transco will not be required to make any CLNG bookings. Transco will only have to make CLNG bookings in the event of insufficient shipper demand and, in this case, Ofgem would judge Transco's CLNG bookings to be consistent with its obligation to operate an economic and efficient pipeline system. The objective of ensuring that all LNG capacity is made available to the market could be frustrated by inappropriate reserve prices. Ofgem would prefer to see no reserve prices but the level of reserve prices, if any, is a matter for Transco. Ofgem will look to Transco in setting any reserve price to ensure that it does not frustrate the objective of ensuring that all capacity is made available to the market.

On the issue of the recovery mechanism for any CLNG costs, Ofgem accepts that the provision of CLNG benefits all users to some extent and therefore believes that the mechanism is consistent with the relevant objectives.

Ofgem's decision

Ofgem has decided to direct Transco to implement modification proposal 451 because we believe that it better facilitates the achievement of the relevant objectives as outlined under Standard Condition 7 of Transco's Gas Transporter's licence. In particular, Ofgem considers that the modification better facilitates the efficient and economic operation of the National Transmission System, as Transco would only have to make CLNG bookings in the event of insufficient shipper demand.

If you have any queries in relation to the issues raised in this letter, please feel free to contact me on the number above, or Amrik Bal on 020 7901 7074.

Yours sincerely

⁵ 'Review of BG Transco plc's Liquefied Natural Gas Storage Facilities: A decision document', Ofgem, March 2000.'

Mark Feather
Head of RGTA