

**OFGEM DECISION LETTER No. 0472**  
"Restoration of Funding for National Top-up"  
Version 1.0

Direct Dial: 020 7901 7374

21 May 2002

Transco, Shippers and Other Interested Parties

Your Ref:  
Our Ref : Net/Cod/Mod/472

Dear Colleague,

**Modification Proposal 472 – “Restoration of Funding for National Top-Up”**

Ofgem has considered the issues raised in Modification Proposal 472 “*Restoration of Funding for National Top-up*” and has decided not to direct Transco to implement the modification because we believe that it does not better facilitate the relevant objectives of Transco’s Network Code. 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 to the proposal**

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, ie. 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).

Ofgas’ view was that the top-up regime was an obstacle to the development of competition in the storage market and that Transco’s recovery of ‘national top-up’ costs, ie. top-up booked by Transco to overcome a supply / demand imbalance (as opposed to CLNG top-up), via the

neutrality mechanism could distort purchases of storage capacity. Moreover, such top-up would not be needed in the long term given the increase in the availability and diversity of peak gas supply sources. In the context of the envisaged development of the storage market and a new energy-balancing regime, shippers would be incentivised to make adequate provision for their peak day needs. Ofgas therefore felt that top-up could be removed from Transco's network code.

Ofgas did, however, take the view that Transco should be allowed to the recovery of CLNG top-up. As indicated above, CLNG has is used for transmission support purposes and so any considerations of these costs would be taken forward as part of the reform of the exit and interruptions regime.

Subsequent storage reviews and Network Code modifications have therefore resulted in Transco currently being able to recover the costs of *efficiently* incurred CLNG top-up costs but not national top-up costs. A full description of related modifications 237, 297, 356, 391 and 451, and Ofgem's views and eventual decisions can be found in our decision letter for Modification Proposal 451 - "*Treatment of Constrained Top-up Costs for Storage Year 2001/02* – implemented in January 2001.

Transco's ability to recover top-up costs has had implications for its obligations contained in its Safety Case with the Health and Safety Executive (HSE). In summary, the Safety Case requires Transco to book any shortfall between total shipper bookings and the monitor level but only to the extent that there is available and unbooked storage capacity. Transco did re-submit its Safety Case in the summer of 1999 but this was 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, although this was not accepted by the HSE.

In December 2001, Transco put forward modification proposal 449 "*Determination of National Top-up Requirements*". This proposal would have changed the basis on which Transco calculated how much top-up gas to provide under the Network Code, so that it met the domestic security of supply standards and did not provide gas to cover non-domestic security of supply. Transco withdrew this modification proposal after the HSE gave legal advice that such a change would be inconsistent with the provisions of the Gas Safety (Management) Regulations 1996 because a distinction could not be made between domestic and non-domestic sites for security of supply. If this change were made, the HSE would reject the consequent amendment to Transco's Safety Case.

Transco has now proposed to restore its ability to recover national top-up costs via this modification proposal.

### **The modification proposal**

Transco has proposed that it be allowed to recover national top-up costs it incurs in its role as top-up manager, via the top-up neutrality mechanism. The proposal does not relate to the costs incurred in booking and filling CLNG top-up. The proposal would broadly mean that the provisions of the Network Code relating to recovering the costs of top-up, which were removed by modification proposal 297 "Top-up Cost Treatment", would be re-introduced.

### **Respondents' views**

Six representations were received in response to the proposal. Five of the respondents did not support implementation of the proposal, and the other respondent had concerns about implementation of the proposal.

Two respondents did not believe that there had been any material change in circumstances since modification proposal 297 "*Top-up Cost Treatment*" had been implemented, which ended Transco's ability to recover net top-up costs through the top-up neutrality mechanism.

Four respondents were concerned that the recovery of costs through the top-up neutrality mechanism would not focus the costs on those shippers causing them to be incurred. In particular, respondents were concerned that the proposal:

- did not reflect the fact that some shippers and suppliers would have made adequate provision to meet the security of supply requirements under their licences;
- recovered the costs from shippers to domestic and non-domestic sites, although top-up was only required to meet security of supply standards for domestic customers; and
- gave the Lattice group an incentive to overstate national gas requirements to the extent this led to LNG services within the Lattice group being booked through the top-up mechanism and the costs recovered from shippers.

Respondents suggested that Transco consider alternative methods to recover the costs of top-up. Some respondents also criticised Transco for not promoting more discussion of alternative methods to recover the costs at the Network Code Planning and Security workstream.

Two respondents were concerned that Transco's proposed changes were being introduced part way through a storage year after shippers and suppliers would have already made provisions to meet their security of supply standards. One argued that if the top-up cost recovery mechanism had been known about when storage and LNG bookings were made, shippers may have made less bookings and relied more on traded gas at the NBP to meet their any relevant licence obligations. The respondents believed that the proposal would undermine the economic basis on which shippers and suppliers decisions about how to meet security of supply standards had been made. Transco believed that it was an advantage if shippers had booked more storage as a result of the lack of a cost recovery mechanism for top-up at the beginning of this storage year.

One respondent argued there were a range of available sources of flexible gas to meet security of supply standards, and that Transco's use of top-up may be distorting investment in these alternatives.

In response to the above, Transco stated its view there had been a material change in circumstances because Ofgas' decision to implement modification proposal 297 had been based on an assumption that the top-up requirements would be removed from the Network Code. This had not occurred because the HSE believed top-up was necessary to comply with the Gas Safety (Management) Regulations 1996.

Transco also believed that the recovery of costs through the top-up neutrality mechanism would better facilitate achieving the relevant objectives of the Network Code by improving the incentive on shippers to book sufficient storage to meet their domestic security of supply standards. Users could raise alternative proposals for cost recovery that better targeted costs but

recovering costs only from shippers with domestic sites would, Transco believes, be inconsistent with the HSE's legal advice that security of supply should be provided for all sites. In any case, Transco was of the view that alternative cost recovery mechanisms had been considered in industry discussions but all had demonstrated significant disadvantages.

Transco endorsed the principle that market mechanisms should provide sufficient flexibility to meet security of supply standards, but suggested that markets may not always provide sufficient 'insurance' for exceptional conditions. It did not believe that it would be able to persuade the HSE to accept its safety case without the use of top-up.

### **Ofgem's view**

Ofgem recognises the importance of security of supply concerns. We consider that a combination of the incentives and signals created by competitive markets and effective regulation should be able to deal with the issues surrounding the security of supply. For example, Ofgem's reforms to the storage market are leading towards a more competitive storage market characterised by an increasing number of storage operators and new facilities. It should also be noted that the current Network Code arrangements provide shippers with strong commercial incentives to balance their inputs and offtakes over the gas day, and particularly on days of tight demand and supply conditions.

Nevertheless, we recognise that Transco's Safety Case with the HSE continues to impose on Transco an obligation in respect of top-up. Transco has attempted to renegotiate its Safety Case as part of both the RGTA process and on other subsequent occasions, but has so far been unsuccessful. The effect of this is that Transco remains potentially liable to pay some top-up costs that it cannot recover, ie. national top-up.

Against this background, consideration has to be given to the nature of this obligation and the basis on which any funding might be permitted. One of the factors that would need to be considered in allowing the recovery of these costs would be the extent to which they had been incurred efficiently. To allow inefficiently incurred costs to be passed through in this way would be contrary to customers' interests.

In assessing whether the costs had been incurred efficiently, Ofgem would have particular regard as to whether other actions that might affect the size of the top-up requirement were carried out in such a way as to minimise the total costs of any top-up requirement. For example, at the LNG facilities, capacity is auctioned on an annual basis, with Transco LNG setting site-specific reserve prices. Certain reserve prices – set by Transco – could lead to the auctions failing to clear. This would result in a quantity of unsold capacity at some of the facilities and this in turn would affect the extent to which Transco would be required to book top-up storage capacity. In some circumstances, permitting the recovery of top-up costs that have been incurred due to the level of reserve prices preventing the auctions from clearing might not, in Ofgem's view, be efficient.

### **Ofgem's decision**

Ofgem has therefore decided not to direct Transco to implement the modification, because we do not believe that the proposal will better facilitate the relevant objectives of Transco's Network Code.

If you have any queries in relation to the issues raised in this letter, please feel free to contact me on the above number.

Yours sincerely,

**Nick Fincham**  
**Director, Gas Trading Arrangements**