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09 November 2001

Transco, Shippers and Other Interested Parties

Dear Colleague,

Modification proposal 0459 'Rebalancing System Entry Charges with respect to Barrow and St Fergus System Entry Points'

Ofgem has carefully considered the issues raised in modification proposal 0459 '*Rebalancing System Entry Charges with respect to Barrow and St Fergus System Entry Points*'. Ofgem has decided to direct Transco not to implement this modification because we do not believe that this proposal will better facilitate the relevant objectives of Transco's Network Code.

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

Background to the proposal

Gas Quality

The Gas Safety (Management) Regulations 1996 (GSMR) specify the range of characteristics permitted for gas to be conveyed in a network. The GSMR state that the calorific value (CV) of such gas, as measured by the Wobbe index, should fall between the range 47.20 and 51.41 MJ/m³. The regulations allow for gas to be transported that fails to meet the GSMR specifications only if it is being transported to either a power station or to be blended with other gas in order to conform to the specifications. In both cases the pipes must be used exclusively for this purpose.

The Barrow terminal is the only NTS entry terminal that delivers gas that has a CV that is below the minimum specifications in the GSMR. This gas is transported to the Lupton multi-junction where it mixes with higher CV gas ensuring that the gas downstream of Lupton meets the GSMR specifications. If the gas downstream of Lupton approaches the lower CV limit the System Operator (SO) will issue a Terminal Flow Advice (TFA) and instruct the terminal operator at Barrow to curtail flows.

In addition to South Morecambe, a number of gas fields deliver gas to the NTS that fails to meet the GSMR minimum CV specifications. The gas from these fields mixes with higher CV gas either offshore or at the entry terminal, resulting in an aggregate CV that falls within the GSMR CV limits. In the absence of adequate blending, processing equipment would have to be installed to ensure that the GSMR are met.

Entry Capacity

In September 1999, Transco conducted the first auctions for the sale of monthly firm entry capacity (MSEC) to the National Transmission System (NTS). The auctions provided for the allocation of firm entry capacity to successful bidders for a period of six months (October 1999 to March 2000). Further auctions for firm monthly entry capacity were held in March and August 2000, and February and August 2001 with entry capacity again sold for a period of six months in each auction. Under the auctions capacity is offered for sale at six main beach entry terminals, St Fergus, Barrow, Teesside, Bacton, Theddlethorpe and Easington. Capacity is also offered for sale at a range of onshore entry points where storage sites are located.

In addition to releasing MSEC, Transco also releases monthly interruptible system entry capacity as well as daily firm and interruptible capacity.

Reserve prices

Under the existing capacity regime Transco applies reserve prices to its sales of MSEC. These reserve prices were established following the implementation of Pricing Consultation 48, 'Methodology for Determining Floor Prices for Auctions of Monthly System Entry Capacity'. Pricing Consultation 48 provides for monthly reserve prices to be set at 75% of the long run marginal costs at each entry terminal.

Under current market structures there are currently only two purchasers of capacity at the Barrow terminal. These entities fall under the same ownership structure and, as such, capacity is sold at reserve prices at this terminal. This is in contrast to other terminals such as St Fergus where shippers compete to purchase capacity and capacity is often sold at prices substantially in excess of the reserve prices that apply at these terminals.

Inter-terminal capacity substitutability

Several shippers have raised concerns that Barrow capacity is to some extent substitutable for St Fergus capacity and that, as such, the current capacity allocation arrangements discriminate in favour of the shipper at this terminal by enabling it to source its capacity rights at a substantially lower price relative to the prices paid by shippers at the more competitive St Fergus terminal.

These concerns have been raised in recent months following the first period of significant capacity constraints in October 2000. During this month, Transco bought back significant volumes of capacity often at prices significantly higher than the price at which capacity was sold in the auctions. Buy-back costs of £8.5m were incurred in this month. In this context, Transco attempted to alleviate the constraint at the 5t Fergus terminal by purchasing capacity at Teesside and Barrow. This suggested some degree of interdependencies and substitutability between these terminals.

More recently as part of its '*Transporting Britain's Energy*' consultation process, Transco highlighted the physical interdependencies of the St Fergus, Barrow and Teesside terminals, showing that capacity availability at one particular terminal can be maximised with appropriate transfers of gas between the three terminals. In general, Transco's analysis suggested that the capacity physically available at one terminal is a function of the capacity used at other terminals

In raising this modification proposal Amerada Hess has indicated that 'it is necessary to eliminate the discriminatory and anti-competitive price differentials in system entry charges which exist between Barrow and St Fergus'. In this context Amerada Hess has indicated that 'Barrow users are currently heavily subsidised by St Fergus users' who are required to pay high prices in the MSEC auctions. Amerada Hess has also indicated that the proposal is in line with the principle that the costs associated with quality issues are appropriately targeted to those shippers who require a gas quality service.

The modification proposal

In its proposal, Amerada Hess seeks to introduce a levy payable by users delivering gas at the Barrow entry point. This charge seeks to reflect the need for a certain quantity of St Fergus gas to be delivered in order to raise the CV of the Barrow gas to the standards set out in the GSMR

The revenue from this levy would be paid to St Fergus users, based on the actual usage of the St Fergus system entry point. Further, Amerada proposed that the levy should be linked to the ratio of St Fergus gas to Barrow gas deemed necessary by Transco to meet the required entry specification for Transco's pipeline system.

It is proposed that the ratio of St Fergus to Barrow gas required for mixing be used to derive an adjusted price differential between the 2 entry points for each month, using the results from the MSEC auctions. The adjustment will become an additional system entry charge for Barrow users, and will generate revenue that will be passed to St Fergus users, to offset their system entry charges.

Respondents' views

The majority of respondents did not support the proposal

Several respondents opposing the modification stated that it would distort pricing of MSEC at St Fergus and impact upon bidding behaviour in the MSEC auctions. A further respondent stated that the modification would introduce even more instability into the NTS capacity charging regime potentially affecting future offshore investment.

A number of respondents indicated that the proposal fails to address the impact that the Teesside terminal may have on the ability of the NTS to accept gas at Barrow and that consideration should be given to providing Teesside capacity holders with any share of the revenue from the any levy.

Transco's view

In its Modification Report, Transco indicate that it does not support the proposal

Transco stated that there is no direct linkage between entry charging and gas blending and the issues discussed in the proposal should be separated. In particular, the proposer's concern regarding the high differential in entry capacity charges at different terminals should be addressed within the context of wider discussions on the NTS entry capacity regime.

Transco stressed that the blending of gas, which is a purely physical process, is undertaken to maintain the required statutory gas quality levels across the network. Transco considers that it is inappropriate that this physical process is considered as a remedy for the price differentials between entry capacity charges at St. Fergus and Barrow. Transco also state that additional gas is not delivered at St Fergus for the purposes of ensuring gas delivered through Barrow meet relevant system specifications. Transco indicates that the quantities of gas delivered through St Fergus are irrespective of the mixing requirements at Lupton.

Transco state that a cost targeting approach to gas blending services would not necessarily achieve a level of charges similar to the level contemplated in the proposal. Transco states that the level of costs would in fact be far less significant than those reflected in the proposal.

Transco added that the Modification Proposal addresses the charges for monthly firm capacity only and takes no account of holdings of monthly interruptible capacity and daily firm and interruptible capacity.

In addition, the proposal to introduce a variable daily adjustment to entry capacity charges at St. Fergus and Barrow may affect shippers' valuations of all capacity products and add additional uncertainty to the capacity charges they are likely to face. This will have the effect that users at Barrow and St Fergus will pay charges for MSEC which differ from those bid in the auctions, undermining a fundamental feature of these auctions.

Ofgem's view

Ofgem agrees with Transco and the majority of respondents that the link created by the proposal between capacity charges and gas blending services is inappropriate.

Ofgem considers, however, that the proposal raises a number of important issues regarding Transco's charges for transportation services and the provision of blending services for managing gas quality.

Ofgem believes that, consistent with Transco's licence obligations and the relevant objectives of the Code, the efficient management of gas quality relies on the accurate targeting of costs to those participants that cause them to be incurred. In its February 2001 gas balancing consultation document¹ Ofgem indicated that any costs associated with the provision of gas quality services should be appropriately targeted to those shippers who require the service.

Ofgem has also indicated in its September 2001 System Operator incentives initial proposals² that, to the extent that Transco provides quality services it should face appropriate financial incentives regarding the provision of these services. Customers and shippers would then be in a better position to determine whether it is cheaper to pay Transco to deliver enhanced gas quality services or invest in their own equipment to manage gas quality issues, for example through investing in facilities offshore.

Transco have provided information to Ofgem that indicates that accepting gas from the South Morecambe field results in three broad categories of directly attributable costs:

- a. additional compressor usage following a small reduction in pressure at the Lupton multi- junction (£28k pa);
- b. the regulated return on assets (additional pipes) installed at the Lupton multi-junction to ensure sufficient mixing of the lower and higher-CV gas (£5k pa); and
- c. a share of operating expenditure to the above assets (£42k pa).

In addition to these costs, Transco have indicated that the process of allocating costs to entry terminals assumes a universal CV for all terminals. Consequently no adjustment is made to allow for the larger volume of gas per unit of energy that needs to be transported from a low-CV terminal compared to a high-CV terminal. Adjusting for this effect would increase the reserve price at Barrow by approximately 4% (0.0003 p/kWh).

Ofgem believes that it is appropriate that costs that are incurred by the system operator because of the actions of an identifiable party, should be met by this party. Whilst Ofgem welcomes any proposal to target the costs attributable to the management of gas quality services at Barrow to the shippers entering such gas onto the NTS, Ofgem does not believe that the proposed levy properly targets or reflects the costs associated with the provision of gas quality services. Further, Ofgem considers that the basis upon which the levy is derived is somewhat arbitrary and does not in this respect achieve better cost reflectivity or effective cost targeting.

Ofgem has reached its view on the basis of the assessment provided above and Transco's view that the level of attributable costs anticipated under any cost targeting approach are likely to be less significant than those reflected in the proposal.

In this context, Ofgem notes Transco's charging methodology objectives contained in its Gas Transporter's licence (Standard Condition 4A). These specify that compliance with 'the methodology results in charges that reflect the costs incurred by the licensee in its transportation business (except where services are sold by way of an auction).

The cost of supplying a product to a particular group of similar customers may be defined and calculated in different ways, but common economic principles may be applied. In economic terms the costs are "the expected cash outlays that would be incurred if the customers are supplied with the product and avoided if they were not. The calculation of such avoidable costs is necessarily forward looking. To ensure tariffs do not unduly discriminate against or prefer unduly any group of customers, then broadly speaking tariffs should at least cover the forward looking avoidable costs directly attributable to each category of customer over the relevant period.

Clearly costs which do not vary according to whether or not particular customers are supplied cannot be directly attributable to those customers. And by definition, costs that cannot be attributed to any particular category of customer cannot be allocated on the grounds of cost causation. Some other criteria is needed to determine the 'mark-ups', where the price to some or all customers needs to be raised above the directly attributable avoidable costs to enable Transco to recover its annual price controlled allowed revenue.

The information provided above suggests that the directly attributable costs associated with the provision of gas quality services are approximately £75k per annum. It also suggests that the methodology used to determine the current reserve prices for the MSEC auctions may need adjusting to take account of the CV adjustment.

As Transco has now identified the directly attributable costs associated with providing blending services at Barrow, Ofgem believes that Transco should review, as a matter of urgency, the manner in which Transco charges for gas quality services and the methodology used to determine reserve prices and the extent to which these charges meet the relevant objectives in both the Network Code and Transco's charging methodology. This review should consider how best to charge shippers using the Barrow terminal, and other terminals and/or exit points where blending or mixing services are required and being provided.

¹ *The new gas trading arrangements, Further reform of the gas balancing regime*, Ofgem, February 2001

² *Transco's National Transmission System -System Operator incentives*, Initial proposals, Ofgem, September 2001.

Ofgem's decision

Ofgem does not believe that this proposal would better facilitate the efficient and economic operation by the licensee of its pipe-line system or the securing of effective competition between relevant shippers and relevant suppliers.

In particular, Ofgem considers that the proposed levy is not sufficiently reflective of the costs associated with the provision of gas quality services for gas entered onto the NTS at Barrow. As such Ofgem considers that the levy does not better facilitate the efficient operation of the NTS. Further / in so far as the levy fails to effectively target the costs of the provision of gas quality services it may also distort competition between relevant shippers.

Ofgem has therefore decided not to consent to this modification because we do not believe that it better facilitates the relevant objectives outlined under Standard Condition 9 of the Gas Transporter's licence.

Ofgem believes, however, that the modification has highlighted an important issue and that Transco should begin a review of the manner in which it charges for the provision of gas quality services and the methodology used to determine reserve prices and the extent to which these charges meet the objectives of its charging methodology and the Network Code. This review should give consideration to the introduction of explicit charges for the provision of gas quality services at relevant entry and exit points (including the appropriate level of mark up over and above directly attributable avoidable costs).

If you have any queries in relation to the issues raised in this letter, please feel free to contact me on the telephone number above or Mark Feather on extension 7437.

Yours sincerely



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Director, Trading Arrangements