

Direct Dial: 020-7901 7437

27 September 2002

Transco, Shippers and Other Interested Parties

Our Ref: Net/Cod/Mod/519

Dear Colleague,

Modification Proposal 0519 *'Removal of Energy Balancing Incentives from the Network Code'*

Ofgem has considered the issues raised in Modification Proposal 0519 *'Removal of Energy Balancing Incentives from the Network Code'*. Ofgem has decided to direct Transco plc ('Transco') to implement the modification because Ofgem considers 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 the reasons for making our decision.

Background to the proposal

Gas balancing – New Gas Trading Arrangements

Shippers have commercial incentives under the Network Code to balance their inputs and offtakes of gas to the system each day. Transco undertakes the role of residual system balancer to the extent that shippers do not balance their inputs and offtakes and the system becomes long or short in aggregate over the gas day. As residual system balancer Transco buys and sells gas on the On-the-day-commodity market (OCM) to ensure that the National Transmission System (NTS) remains in balance and that linepack remains within safe operational limits. When linepack is falling (i.e. offtakes exceed inputs) Transco may buy gas. Conversely, when system inputs exceed offtakes Transco sells gas to bring the system back into balance.

Transco's Gas Balancing Incentive

When the New Gas Trading Arrangements were introduced on 1 October 1999, Transco was given a price-based incentive to balance its NTS efficiently. The new incentive was intended to better align Transco's interests with those of its customers, who ultimately pay for the costs of Transco's balancing actions. Previously, Transco was not exposed to the costs associated with its balancing actions.

Transco's balancing incentive was introduced by Ofgem's acceptance of Modification Proposal 0313 *'Development of the Energy Balancing Regime to Facilitate implementation of the on-the-day-commodity market'*. Under the incentive, Transco received benefits depending on how close the price of Transco's marginal trade was to the System Average Price (SAP) on the OCM. The incentive applied to both buy and sell actions. If Transco's marginal trade was within 5% of SAP on any day, Transco received a bonus payment up to £2,000, which it received if it traded at SAP. Transco was also exposed to a daily penalty of up to £15,000 if the differential exceeded 5%. An annual cap and collar of £2 million for both the penalty and reward was also applied, that was further divided into monthly caps and collars.

Following Ofgem's acceptance of Modification Proposal 0414 *'Proposal to reform the Transco Energy Incentive Redesign'* on 30 March 2001, Transco's energy balancing incentive was revised to include a linepack target. Previously, there had been concerns that the price incentive alone might lead to a mis-targeting of balancing costs from day to day by encouraging Transco not to take system balancing actions on a given day. In particular, concerns existed that Transco was using system linepack to avoid taking actions and therefore carrying imbalances over from day to day. There were also concerns that this use of linepack could reduce liquidity on the OCM. The linepack incentive was introduced to address each of these concerns.

Under the revised incentive regime, Transco was provided with two separate incentives: a price incentive and a linepack incentive. Transco's total revenue/cost under the balancing incentive was the sum of the incentive payment received under both its price incentive and its linepack incentive. Under the linepack incentive Transco could receive up to £4,000 per day if there was no difference between

opening and closing linepack. If the difference between opening and closing linepack was greater than 2.4 mcm, Transco would be exposed to a penalty of up to £30,000 per day.

Ofgem's decision on 28 March 2002 to accept Modification Proposal 0542 '*Revised Energy Balancing incentive Arrangements post April 2002*' amended the parameters of the existing linepack and price incentives. In particular, Transco's potential rewards under both its price and linepack incentives were increased to a maximum of £5,000 per day. In addition, Transco's annual maximum revenue and exposure for both incentives was increased to £3.5 million.

Transco System Operator Incentives proposals

Ofgem published its final proposals for Transco's NTS System Operator (SO) incentives for 2002–7 in December 2001.¹

On 12 April 2002, the Authority issued a notice ('the Original Notice') under section 23 of the Gas Act 1986 ('the Act') to modify the Gas Transporter (GT) licence of Transco. The modifications concerned Transco's transmission asset owner ('TO') price control, its system operator ('SO') incentives, and its metering activities for the period to April 2007. The modifications also concerned the disclosure of Transco SO information and the ability of third parties to raise modifications to Transco's Network Code. The Original Notice was accompanied by an explanatory document ('the Explanatory Note') that was also issued on 12 April 2002.²

Following careful consideration of the responses that were received to the 12 April Original Notice, Ofgem identified and logged a number of drafting changes to the proposed licence modifications as originally consulted on. During the consultation several respondents suggested that if the Authority decided to make changes to the proposed modifications, there should be a further consultation. The Authority considered this and concluded that the changes identified fell within its powers under section 23 of the Act and the terms of the Original Notice and as such the Authority had the power to direct that the modification be made. However, the

¹ '*Transco's National Transmission System Operator Incentives – Final proposals*', Ofgem, December 2001.

² *Transco Price Control and NTS SO incentives 2002–7, Explanatory notes to accompany the section 23 notice of proposed modifications to Transco's gas transporter licence*, Ofgem, April 2002.

Authority considered that, in recognition of concerns expressed by respondents, there should be a further limited consultation on this occasion.

Against this background, on 1 August 2002, the Authority issued a further section 23 notice ('the Second Notice') in respect of Part A only of the proposed modifications to Transco's GT licence. This Second Notice was accompanied by a log³ of the proposed changes ('the Log') that were made to the proposed licence modifications attached to the Original Notice. The closing date for responses to the Second Notice was 30 August 2002. The Second Notice was also accompanied by an open letter to industry. Each of these documents is available on Ofgem's website.

The Authority has now carefully considered the responses to each section 23 notice and has identified a number of further minor changes to the drafting in respect of Part A of the Second Notice and in respect of Part B.

The Authority has concluded that the licence modification proposals as amended by the changes that have been identified in response to the Second Notice fall within section 23 of the Act. In particular, Ofgem considers that no further consultation is necessary as the further changes fall within the Authority's powers to make incidental and consequential modifications under section 23. The changes that have been identified are consistent with the Original Notice, the Second Notice, the Explanatory Note and the Log. A second log of changes ('the Second Log') has been prepared setting out the modifications made to the licence modification proposals as consulted on in the Second Notice. The Second Log is available from the Ofgem website.

On 26 September 2002, Transco gave its written consent to the modifications as amended (in the form of the direction) and the Authority has received confirmation from the Department of Trade and Industry that the Secretary of State does not intend to exercise her power of veto under the Act with respect to the proposed modifications.

In this context Ofgem has therefore today issued a direction ('the Direction Notice') to implement the proposed modifications to Transco's GT licence with effect from today (27 September 2002). In accordance with Ofgem's press statement dated 22 February 2002, the Direction Notice and the associated modifications have

³ *'Log of changes to the proposed licence modifications'*, Ofgem, August 2002

retrospective effect from the date of introduction and shall apply from on and from 1 April 2002. A copy of the Direction Notice and associated licence modifications is available on the Ofgem website.

The proposal

This proposal would remove the existing Network Code provisions relating to Transco's energy balancing incentive.

Respondents' views

Most respondents did not support the proposal. Some respondents gave qualified support.

Most respondents that did not support the proposal were concerned that removing the incentive from the Network Code would remove shippers' ability to effect changes to the regime. Many respondents expressed the view that the incentives impacted financially not only upon Transco but also upon shippers. As such, they were of the view that shippers should be able to propose changes to the regime in future.

One respondent indicated that if the parameters of the incentive regime go into Transco's licence it would be impossible for shippers to make changes if, for example, the incentives were set too far in Transco's favour.

One respondent added that the modification would reposition Ofgem's role in the contractual arrangements between shippers and Transco and at the same time undermine the position of shippers. It did not believe that this would improve the efficient operation of the pipeline system and argued that recent experience with the buy-back incentive did not give confidence that Ofgem is always able to accurately forecast Transco's likely buy-back requirements.

Some respondents that did not support the proposal also stated that the modification proposal was premature because shippers had not had the opportunity to see and make comments on the proposed licence modification proposals. Two respondents qualified their support of the proposal because they felt that the consultation on the removal of incentives from the Network Code should have been concurrent with debate on the proposed licence modifications.

One of these respondents recognised the merits of placing the incentive regime in Transco's licence but felt that it should only reside in the licence when there is greater certainty about the regime structure and the interaction of the incentives. This respondent indicated that previous experience had suggested that there is often a need to amend Transco's incentives and that they should continue to reside in the Network Code until more confidence is gained regarding the incentive regime. Another respondent indicated it had significant concerns with the removal of the incentive from the Network Code during a period of significant change and uncertainty regarding the gas balancing regime. In this context, the respondent indicated that it was appropriate for both Transco and shippers to have an opportunity to review the scheme and initiate revisions to it through the Network Code.

One respondent supported the proposal, viewing it as an essential part of implementing the new SO incentives by ensuring consistency between Transco's GT licence and the Network Code. This respondent supported placing as many elements of the incentives in Transco's licence to reduce the level of regulatory uncertainty.

Transco's view

Transco's justification for raising this proposal is to facilitate the implementation of Ofgem's proposals for Transco's System Operator (SO) incentives, particularly relating to specifying Transco's residual gas balancing incentive in its GT licence. Transco stated that, in the event that its residual gas balancing incentive is specified in its GT licence, it would be necessary to remove the incentive provisions from the Network Code to reduce the risk of a conflict arising between the terms of the Network Code and Transco's GT licence. As such, it argued that the proposal better facilitated the efficient discharge of its licence obligations.

Transco has indicated that were the proposal to be implemented shippers will still have the ability to make informal representations to Ofgem if they believe that it would be in the interests of the industry and consumers to have the incentives modified. Further, Transco does not share the view that the migration of the incentive into the licence would prevent the further development of the energy balancing regime.

Further consultation

In August 2002, Transco conducted a further consultation on this modification proposal pursuant to the Network Code Modification Rules. A small number of responses were received to this additional consultation.

Respondents' views

One respondent stated that whilst holding the incentives in the licence may provide greater stability for Transco, it nevertheless believed that the benefits afforded by this stability were outweighed by the reduction in flexibility and the ability of shippers to work with Transco develop the incentive regime. The respondent proposed that a small expert group be established to evaluate interactions between the Network Code and the licensing regime.

Another respondent reiterated its view that the incentives belong in the Network Code. A further respondent indicated that if Ofgem directs its proposed licence modifications then the incentive structure within the Network Code becomes redundant and, if not, there is a need for the incentive regime to remain in the Network Code.

Transco's view

Transco's view in relation to the proposal was not materially altered from the view it expressed in its original final modification report.

Ofgem's view

As outlined above, Ofgem has today issued a Direction Notice to implement the proposed modifications to Transco's GT licence with retrospective effect from 1 April 2002. Amongst other things, these licence modification proposals introduce a new gas balancing incentive into Transco's licence with the same parameters of the gas balancing incentive that is contained within the network code and which forms the subject of this modification proposal.

In view of this development Ofgem considers that the removal of Transco's Network Code gas balancing incentive would better facilitate the efficient discharge of Transco's GT licence obligations as they presently exist. In particular, Ofgem

considers that it is inappropriate for Transco to be subject to both a network code and a GT licence gas balancing incentive going forward.

Ofgem notes that a number of respondents have raised concerns regarding the removal of the incentives from Transco's network code into Transco's GT licence. As we have outlined in our open letter to the industry issued today accompanying the direction to modify Transco's GT licence, Ofgem considers that it is important that those elements of the incentive regime (including its gas balancing incentive) that have a potentially material impact upon Transco's financial position should be included within its GT licence.

Further, Ofgem considers that it is important to provide Transco with a sufficient degree of certainty in order to allow it to fully respond to its incentives. The stability offered by inclusion of the incentives regime in the GT licence should provide that certainty. The removal of the incentives regime from Transco's Network Code should also provide the stability that some shippers have asked for.

Ofgem also considers that the inclusion of the incentives in the licence is consistent with the governance of NGC's incentive regimes. Consistency in the governance of both Transco and NGC's SO incentives is important given the increasing interactions between the two markets.

The licence modifications envisage regular reviews of the SO incentives including the review of various elements of the SO incentive package from 1 April 2004. All parties will have the opportunity to be involved in these reviews. In addition, shippers will also have the opportunity to informally raise with Ofgem any concerns regarding the operation of the incentives.

As an additional point, shippers also have the ability to request that the Authority directs Transco to undertake a review of its System Management Principles Statement in the event that shippers have concerns regarding the manner in which it is deploying its various system management tools under its SO incentives.

Ofgem's decision

For the reasons outlined above Ofgem has decided to direct Transco to implement this modification proposal because it better facilitates the achievement of the

relevant objectives as outlined under Amended Standard Condition 9 of Transco's GT licence.

If you have any queries in relation to the issues raised in this letter, please feel free to contact me on the above number or Lyn Camilleri on 020 7901 7431.

Yours sincerely,

Mark Feather
Head of New Gas Trading Arrangements