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Shippers, Transco and Other Interested Parties

01 December 2003

Dear Colleague,

Modification Proposal 0659 – ‘Winter Injection Cost Allocation Based on User Daily Imbalances’ and Modification Proposal 0660 – ‘Winter Injection Cost Allocation Based on User Daily Offtakes’

Ofgem has considered the issues raised in both modification proposals and has decided not to direct Transco to implement either modification. In this letter, we explain the background to and nature of the modification proposals, and give our reasons for making this decision.

Background

Transco’s GT licence requires it to operate a system that can meet the peak aggregate daily demand that is only likely to be exceeded once in every twenty years taking into account weather derived from at least the previous fifty years through a number of measures, ie. the 1-in-20 and 1-in-50 standards .

In using storage facilities to help meet these obligations, Transco sets a ‘monitor level’ at long, medium and short duration facilities (as defined in Section P of the network code) respectively. These opening monitor levels represent Transco’s estimate of the volume of gas in store needed at different times of the year to ensure that the above security standards can be met.

Transco’s Safety Case with the Health and Safety Executive (HSE) requires it to make good any shortfall between this monitor level and total shipper bookings by purchasing ‘national top-up’ gas in its role as the ‘Top-up Manager’. Even where Transco has had to do this ahead of the winter, shipper withdrawals during the winter period could cause stocks of gas in store to fall below the monitor levels, and could precipitate further action on the part of Transco.

The modification proposals

0659 – ‘Winter Injection Cost Allocation Based on User Daily Imbalances’

Transco proposed that in the event that on one or more days the Top-up Manager determines a Winter Top-up Injection Requirement and in consequence injects gas into storage, the

associated costs incurred by the Top-up Manager, including storage costs and net gas costs, would be recovered from users in accordance with the following principles:

- The net costs arising from Winter Injections would be established over the Winter Period ("Net Counter-Injection Costs").
- A basis (expressed in kWh) would be determined over which such costs would be recovered ("Recovery Quantity").
- A unit charge would be derived from the Net Counter-Injection Costs and the Recovery Quantity ("Counter-Injection Charge Rate"). This charge rate would be applied to the individual user contributions to the Recovery Quantity.
- The approach to derive Net Counter-Injection Costs would allow for the fact that Top-up revenue, either resulting from acceptance of a Top-up Market Offer or, as a result of subsequent Top-up stock disposal, does not separately identify gas procured prior to the Winter Period and gas procured through Winter Injections. It is therefore proposed that, as such revenues in future winters might arise in respect of Top-up gas purchased ahead of the winter, the resultant revenues be attributed in cost proportions in order to identify net costs arising from pre-winter and within-winter Top-up procurement.
- The Recovery Quantity would be set to equal the sum of all users' negative daily imbalances on Days where the D-1 Demand Forecast exceeded a predetermined demand threshold ("Top-up Relevant Days Threshold").
- This Top-up Relevant Days Threshold would set to equal the 95% of maximum daily supply (ie beach gas plus Continental Interconnector import) identified within Transco's annual Top-up statement.
- The Counter-Injection Charge Rate would be set as the Net Counter-Injection Costs divided by the Recovery Quantity.

0660 - 'Winter Injection Cost Allocation Based on User Daily Offtakes'

This modification proposal puts forward the same methodology as modification proposal 0659 with the exception of the way in which the Recovery Quantity is set. Under modification proposal 0660, the Recovery Quantity would be set to equal the sum of Users' Daily Quantities Offtaken (UDQOs) (excluding those associated with storage injections) rather than users' negative daily imbalances (as in modification proposal 0659), on days where the Top-up Manager made winter injections.

Transco's views

Transco is of the opinion that either one of the modification proposals is required to incentivise users to make adequate provision for 1-in-50 winter condition requirements. In the absence of attributing costs associated with top-up to users, Transco believes that users will not be incentivised to ensure that they provide gas consistent with these requirements. This is particularly important given Transco's reassessment of this winter's supply / demand scenario and that likely to exist over the next two to three years.

Transco also believes that either modification proposal would enable the top-up mechanism to deliver the 1-in-50 standard and anticipates that this would lower the risk of a winter injections being required. However, while supporting the implementation of either proposal, Transco takes the view that modification proposal 0659 has better cost targeting qualities.

Finally, Transco comments that while respondents indicated that they could not have foreseen the basis of modification proposal 0659 prior to making their storage bookings for this winter that was not the case for modification proposal 0660. Modification proposal 660 is based upon the cost allocation methodology contained in modification proposal 583 – ‘*Top-Monitor Cost Recovery*’ – which was rejected by Ofgem in August 2003.

Respondents’ Views

There were sixteen responses to each modification proposal. Fifteen respondents voted against modification proposal 0659, and one gave it qualified support. All sixteen respondents voted against modification proposal 0660. The main points were:

- The current cash out regime provided an adequate commercial incentive for shippers to meet their obligations;
- Transco had not adequately demonstrated that this really was a security of supply issue or rather more one of cost recovery? This proposal would not see more gas enter the system but sought instead to redistribute existing costs;
- Either proposal could encourage shippers to make inefficient levels of storage bookings as shippers sought to prevent a ‘counter nomination’ by Transco;
- These proposals would be incompatible with Transco’s balancing incentives in that there would be no incentive of Transco to minimise the volume and price of top-up gas purchased and would also give Transco the ability to maximise benefits from their balancing incentives;
- Given the fact that top-up had rarely been used and hence the charges would be unpredictable, some shippers commented that any *efficiently* top-up costs should be considered as an Income Adjusting Event under Transco’s price control ;
- The date of implementation, ie. 1 Dec 2003 would impact on shippers as they would be unable to readjust their commercial positions to take into account either proposal (as storage bookings and interruption contracts were already in place); and
- Little more than two months after Ofgem had rejected Transco’s last attempt to resurrect top-up funding (modification proposal 583), Transco revisited its top-up forecast and came up with ‘more realistic’ assumptions regarding storage, interruption and beach information.

HSE’s Views

As the HSE is not a party to the network code, it does not formally respond to network code consultations. However, under the Memorandum of Understanding between Ofgem and HSE, the HSE recently wrote to Ofgem to clarify its views on the issue of top-up and Transco’s recent decision to review the top-up monitor levels. That letter is attached as an Appendix 1 to this decision letter.

Ofgem’s Views

Ofgem continues to believe that security of supply concerns are best addressed through a combination of incentives and signals created by competitive markets and effective regulation, eg. reforms to the storage market and the network code arrangements that provide shippers with strong commercial incentives to balance their inputs and off-takes. Moreover, as we have commented before, Transco’s purchases of top-up are a potential source of inefficiency and could also have a distortionary effect on, for example, shippers’ purchases of storage.

With respect to both modifications, Ofgem notes the comments made by several respondents that the proposals appear to be more concerned with cost recovery rather than the attribution of costs to incentivise shippers as part of a wider concern regarding security of supply issues. In that context, the timing of the proposals has been unhelpful as there has been insufficient time to ascertain the robustness of either Transco's methodology or its recent decision to raise the top-up monitor levels (without reference to either Ofgem or the wider industry).

For instance, Transco does not appear to have taken into account the commercial framework and incentives that would lead to shippers to recycle their storage bookings, a point that Ofgem has previously made to Transco. It is, therefore, interesting to note that at the beginning of December, storage and LNG inventory levels remain extremely high even though gas withdrawals have already taken place earlier in the winter period, thus providing evidence of storage stocks being recycled.

Consequently, as Transco has yet to demonstrate the robustness of neither its methodology or its conclusions, it would be inappropriate to put in place arrangements that could put in jeopardy the commercial basis on which shippers have already prepared for this winter.

However, given the importance that Ofgem places on the issue of security of supply and to deal with any residual concerns that may manifest themselves this winter, it would be advisable to keep open the option of treating *efficiently* incurred top-up costs within the context of an Income Adjusting Event to Transco's price control. Ofgem will also consider after this winter the possibility of reviewing the role that top-up plays within the wider context of security of supply considerations, a review in which all industry participants and the HSE could take part.

In the meantime, Transco has indicated to Ofgem that it would be advantageous to have aggregated storage inventory levels made available to the market. This could, for instance, be done on a weekly basis. This seems to Ofgem a sensible idea, although one that would require the agreement of storage operators. Centrica and Scottish and Southern Electric have already indicated their willingness to make available information relating to their respective facilities on such a basis.

Ofgem's decision

Ofgem has decided not to direct Transco to implement either modification because we believe that it does not better facilitate the relevant objectives in Transco's Gas Transporters licence.

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

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Kyran Hanks', with a long horizontal line extending from the end of the signature.

Kyran Hanks
Director, Gas Trading Arrangements

Appendix 1 – Letter from HSE to Ofgem

*Specialised Industry Division
Head of SI3: Steve Wing*

OFGEM
9 Millbank
LONDON
SW1P 3GE

Your refn:

Our refn: Ofgem
03 Top Up

**For the attention of Kyran Hanks,
Director - Gas Trading Arrangements**

3 November 2003

Dear Kyran

GAS SAFETY (MANAGEMENT) REGULATIONS 1996 (GSMR) HEALTH & SAFETY AT WORK ETC. ACT 1974

I write with reference to Transco's Winter Operations Report 2003 – 2004 and the implications for the existing Top Up regime and 1 in 50 security of supply standard.

Although the Report addresses the interactions between the gas and electricity markets and the implications for gas and electricity supply security, our immediate focus and concern is for the security of gas supplies and prevention of a gas supply emergency.

We have had the opportunity to discuss these matters with Transco and I now write to clarify our views on the legal position in relation to Transco's duties under GSMR and their accepted safety case.

GSMR, Schedule 1, sets out the details that should be included in a gas transporter's safety case. Of particular relevance is the requirement that the safety case includes particulars to demonstrate that Transco have established adequate arrangements to minimise the risk of a supply emergency. Also, the guidance to GSMR states that, 'The safety case should describe the procedures for monitoring changes in the gas supply market to ensure that arrangements for meeting the cold winter criterion can continue to be met'.

In accordance with the above, the safety case describes how Transco assess and forecast gas supply and demand levels (both short and long-term) using a variety of data sources and the arrangements in place for preventing a gas supply emergency. The safety case also makes specific reference to the use of Top Up gas in terms of providing incentives to gas suppliers to meet security of supply requirements (1 in 20 peak day and 1 in 50 severe winter).

Transco are required to follow the procedures and arrangements set out in their safety case. As such, in forecasting supply and demand and reaching conclusions about the tools to be used e.g.

setting of the required top up monitor level, it is our opinion that Transco should use the best information/evidence available from the relevant data source e.g. Transco's operational experience and factual information relating to the reliability and availability of beach supplies and changes in shipper use of storage gas in preference to interruptible capacity. If this information indicates that changes are required to the assumptions previously used by Transco in determining supply security, it is our view that they should be made.

Also, if consideration of the best evidence leads Transco to conclude that the current top up monitor level will not provide 1 in 50 supply security, we believe that they are obliged to adjust the level accordingly. We understand that Transco are in fact proposing to publish a raised monitor next week.

We are aware that there are two Network Code modification proposals (0659 and 0660) currently out for consultation regarding the recovery of costs arising from any counter-nominations made by the Top Up Manager. Whilst the question of 'who pays' is not strictly a matter for HSE, if Transco continue to bear the cost of Top Up, it seems to us that shippers will have little incentive to retain gas in store to meet the 1 in 50 criteria. 1 in 50 has been one of the benchmark standards for security of supply for many years and we would be extremely concerned to see any diminution of this standard. We therefore ask that OFGEM take account of this in considering the future operation of the Top Up mechanism.

I am attending an HSE/Ofgem liaison meeting at Rose Court in London on 5 November when I shall raise this issue briefly with your colleagues. However, I would welcome the opportunity to discuss with you these and other related matters in more detail and will contact you to arrange a meeting in the near future.

Yours sincerely

S K Chatfield
HM Inspector of Health and Safety