Shippers, Transco and other interested parties

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Dear Colleague,

Network code modification proposal 0684 *Revised ratchet charge regime for breaches of provisional maximum capacity* and network code modification proposal 0684a *Revised ratchet charge regime for breaches of provisional maximum capacity – Transco alternative*

Network code modification proposal 0684 *Revised ratchet regime for breaches of provisional maximum capacity* was raised by BP Gas marketing Ltd (BP) on 27 April 2004.

Transco concurrently raised network code modification proposal 0684a *Revised ratchet regime for breaches of provisional maximum capacity – Transco alternative*.

Having regard to its statutory duties and Transco's obligations under its Gas Transporter (GT) licence, Ofgem has decided to direct Transco to implement modification proposal 0684a. Ofgem has also decided to direct Transco not to implement modification proposal 0684.

This letter explains the background to the modification proposals and gives the reasons for the decision.

Background

Exit capacity regime

Under the current exit arrangements, Transco allocates capacity on an administrative basis among Daily Metered (DM) Supply Points, Non Daily Metered (NDM) Supply Points and non-NTS Connected System Exit Points (CSEPs).

Each user is registered as holding supply point capacity (also referred to as supply point offtake quantity or SOQ), which is subject to a maximum and a minimum requirement. Under Transco's network code, shippers are required to nominate or amend SOQ data for a supply point taking account of historical information and future load requirements.

Ratchet charges

Ratchet charges are intended to provide incentives for shippers to book sufficient SOQ for each of their firm DM supply points and to ensure that Transco has made sufficient capacity available to firm DM sites to meet demand in peak flow conditions.

In the event that exit flows at a DM supply point, i.e. the supply point daily quantity (SPDQ), exceeds the SOQ during the winter period (defined as the months from 1 October to 31 May) shippers incur a supply point ratchet charge for the quantity of gas that exceeds the SOQ. In most of these instances the SOQ would be increased to the level of the SPDQ from the day after the breach. However, if the SPDQ is in excess of the provisional maximum SOQ (PMSOQ or PMC) the new SOQ is capped at the PMSOQ. The PMSOQ is the deemed maximum offtake capacity for the supply point and it cannot exceed two times the SOQ.

The ratchet charge is two times the sum of the applicable annual LDZ capacity charge and the applicable annual rate of the capacity variable component (if any) of the customer charge. The network code also sets out ratchet charges in the event where SPDQ repeatedly exceeds the capped SOQ over the winter period.

In circumstances where there is no scope for the supply point to reduce its actual usage below the SOQ, shippers must seek approval from Transco to increase the SOQ in order to avoid ratchet charges. In determining whether such approval can be granted Transco takes account of the existing pipeline capacity availability and whether further system reinforcement would be required.

Other relevant modification proposals

In August 2003, BP raised modification proposal 0645 *Treatment of sites where continuous SOQ breach (supply point ratchet) has occurred* which proposed to keep the ratchet charge at two times the relevant capacity charges for 'day 1' of the breach, but to reduce 'day 2' charges in the event that a shipper demonstrated that it had sought to address the breach with a request to Transco for a capacity increase. This proposal aimed to address concerns that the existing ratchet regime could lead to severe charges for some shippers and could be open to legal challenge for being penal.

Due to implementation constraints within Transco's systems, BP withdrew its proposal and Transco raised urgent modification proposal 0652 *Revision of supply point ratchet charge multiplier for gas year 2003/04* as a temporary solution to the concerns raised by BP.

Modification 0652 proposed that in the event that the SPDQ of a firm DM supply point exceeded the SOQ in the first instance and repeatedly breached the capped SOQ, the charge for the excess quantity of gas offtaken would be the product of the ratchet charge and a multiplier of 0.01. The ratchet charge would be the sum of the annual capacity charge and the capacity variable component of the customer charge.

Ofgem approved this modification as an interim measure to be applied from 1 October 2003 to 31 May 2004 only. From 1 October 2004, the ratchet charge multiplier would revert from 0.01 to 2.

The proposals

Network code modification 0684

It is proposed that in any month within the relevant period (i.e. from 1 October to 31 March) where gas is consumed in excess of the PMC on any day or days at a Firm DM Supply Point Component, the shipper would be liable for a ratchet charge. In particular, the two following charging regimes would be applied:

- where the SOQ of the Firm DM Supply Point Component is below the PMC, the SOQ of the Firm DM Supply Point Component would be set equal to the PMC for the gas day following the breach. The charge would be the product of the ratchet charge and a multiplier of 1. The ratchet charge would be the difference between the annual capacity charge for the SOQ at the maximum daily usage in that month and the annual capacity charge for the SOQ on the 1st of the month in question;

- where a shipper request for an SOQ increase is made to and approved by Transco, the shipper would be charged at a Premium Daily Charge until the Firm DM Supply Point Component SOQ is reset. The Premium Daily Charge would be set based on the normal daily charge for the SOQ requested by the shipper uplifted by 10 per cent, less the daily charge for the SOQ of the Firm DM Supply Point Component. This charge would be waived for those days that are already covered by the ratchet charge.

Under the second charging regime, where a request for an SOQ increase is made to Transco and it is deemed to require site works, the Premium Daily Charge would be applied for 48 Days. Once a shipper accepts a site-works quotation to carry out site works to make the necessary capacity available under the applicable design criteria, it would only be subject to the Premium Daily Charge for any remaining relevant period until completion of the site works.

Network code modification 0684a

It is proposed that where in a month, from October to May inclusive, a supply point offtakes more in a day than the PMSOQ, the ratchet charge will be waived except for the day of the month on which the maximum breach occurred.

Respondents' views

There were five respondents to the proposals, with the majority supporting modification proposal 0684. Most respondents agreed that a new approach to charging for breaches of SOQ is necessary and that both proposals endeavour to resolve similar concerns with the existing arrangements. A number of respondents commented that the existing arrangements do not provide appropriate incentives for shippers to remedy cases of continuous breaches of SOQ. Two respondents reiterated concerns that the existing arrangements could be considered too penal.

Specific comments with regard to the two proposals are summarised below.

Network code modification 0684

Three respondents stated their preference for modification proposal 0684. They maintained that proposal 0684 introduced a better incentive for shippers to resolve continuous SOQ breaches by providing a reward (in terms of reduced charges) to shippers attempting to resolve their breaches rather than just a penalty for the breach.

The main concern that respondents raised about this proposal was the increased complexity that it would bring.

Network code modification 0684a

The majority of respondents maintained that modification proposal 0684a did not provide an appropriate incentive to resolve continuous breaches once they had occurred. However, several respondents indicated that proposal 0684a offered a simpler incentive framework.

A number of respondents stated that this proposal did not take into account the actions of shippers attempting to resolve the breaches through site-works applications. In this respect, they added that the timing for processing such applications was out of their control.

One of these respondents, while recognising the simplicity of proposal 0684a over proposal 0684, suggested an alternative option to take account of shippers actively attempting to increase their SOQ. Specifically, this respondent proposed developing a simple process whereby shippers can retrospectively claim back ratchet charges from Transco upon evidence that they have successfully increased their PMSOQ.

Only one respondent fully supported modification proposal 0684a, stating that it was the most pragmatic solution. This respondent disagreed with the argument that breaches of SOQ can only be managed retrospectively. The respondent stated that one of the main reasons for implementing modification 0652 was to encourage applications for SOQ increases prior to the introduction of a longer-term solution for the ratchet regime. However, Transco has not received any applications in this respect.

Transco's view

Transco supported implementation of modification proposal 0684a for the following reasons:

- the assumption of proposal 0684 that breaches of PMSOQ can only be managed retrospectively is flawed, as demonstrated by the lack of SOQ increase requests following implementation of modification 0652;

- proposal 0684a would provide an incentive for shippers to manage their offtakes pro-actively rather than trying to resolve PMSOQ breaches after the event;

- proposal 0684, by reducing charges to shippers attempting to resolve their breaches, could be construed as giving them approval, once an offtake rate increase request has been submitted, to continue to offtake in excess of the contractually agreed maximum;

- proposal 0684a would provide the most pragmatic solution upon consideration of the additional complexity and operating costs that proposal 0684 could introduce.

In its final modification report, Transco recognised some merits in the adoption of a process to claim back ratchet charges in the event that a shipper had successfully increased its PMSOQ. Transco expressed its willingness to develop and re-consult on this principle, which was suggested by one respondent. Transco also stated that it would support a further modification proposal that captured the sentiments of this proposed enhancement.

Ofgem's views

As outlined in the decision on modification 0652, ratchet charges are, in principle, an appropriate means of providing an incentive on shippers to book the correct level of supply point capacity, thus allowing Transco to plan and manage its transmission system. Nevertheless, the existing level of ratchet charges may not reflect the costs imposed on the system by those shippers who are in breach of their SOQ limits. In this respect, the ratchet charge that shippers could incur under the current arrangements may not facilitate competition between shippers and suppliers.

Modification proposals 0684 and 0684a are designed to address similar concerns with regard to the current ratchet charge regime. As such, Ofgem has considered which one, if any, would better facilitate the relevant objectives of Transco's network code under standard condition 9 of Transco's GT licence.

Both proposals would improve the current arrangements by removing the risk of unnecessarily severe charges. This would in turn help secure effective competition between relevant shippers and suppliers. Modification proposal 684a would provide stronger incentives on shippers and their customers to jointly work to resolve breaches of SOQ limits. In particular,

- proposal 0684 would not introduce sufficient incentives on shippers and customers to work together in order not to breach their PMSOQ while they are attempting to increase their agreed capacity limits. The proposed reduced ratchet charge, namely the premium daily charge, would not encourage shippers to comply with their contractual obligation not to offtake gas in excess of their agreed maximum during the breach resolution process;

- although shippers would be attempting to resolve their breaches while paying the reduced charge, they should still be responsible for complying with their nominated SOQ by effectively managing their offtakes. By failing to better manage their offtakes, shippers may prejudice the efficient and safe operations of Transco's transmission system. This is not addressed by the incentive regime designed by proposal 0684;

- to the extent that ratchet charges would be passed on to consumers, proposal 0684a would provide stronger incentives on consumers to keep their shippers updated with respect to their capacity requirements and to better manage their consumption until their SOQ limits are effectively increased.

Therefore modification proposal 0684a would encourage shippers to manage their required capacity limits more effectively than proposal 0684 by maintaining strong incentives to prevent breaches until the SOQ limits have been actually increased. This should lead to correct SOQ nominations, thus facilitating the efficient and economic operation of Transco's pipeline system.

Furthermore, modification proposal 0684 would add unnecessary complexity to the ratchet incentive scheme.

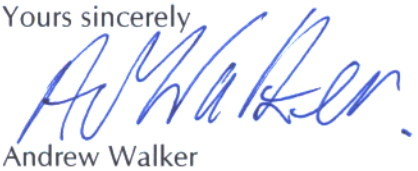
There may be merits in reflecting the efforts that a shipper undertakes in rectifying its SOQ breaches either through site-works applications or other means, although shippers only have limited control over the timing and success of this application process. In the light of these considerations, there may be benefits from the proposed process of claiming back ratchet charges once capacity limits have been effectively increased. Ofgem considers that it is now open to Transco and shippers to raise more detailed proposals in this respect.

Ofgem's decision

For the reasons outlined above, Ofgem has decided to approve modification 0684a and to reject modification proposal 0684, as modification 0684a better facilitates the relevant objectives of Transco's network code under standard condition 9 of Transco's GT licence. In particular, Ofgem considers that modification proposal 0684a better facilitates the effective competition between relevant shippers and relevant suppliers and the efficient and economic operation of Transco's pipeline system.

If you have any further questions regarding this letter please do not hesitate to contact Samanta Padalino on 020 7901 7033 or Matthew Young on 020 7901 7266.

Yours sincerely



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