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Relevant Gas Transporters, Shippers
and other interested parties

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Dear Colleague

Uniform Network Code (UNC) modification proposal 011: 'Reintroduction of Constrained Top-up'

Ofgem¹ has considered the issues raised in the modification report in respect of modification proposal 011 '*Reintroduction of Constrained Top-up*²' and has decided not to direct the relevant gas transporters to implement this proposal.

Background to the proposal

Under Standard Special Condition A9 of their GT licence, relevant gas transporters, including Transco NTS, are obliged to plan and develop their pipeline systems to meet certain security standards. One such standard is that the pipeline systems 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 the 1 in 20 network planning standard. Transco NTS meets this planning standard through a number of measures, including investment in pipelines, the use of interruptible transportation terms and the use of storage facilities. During periods of high demand, Transco Liquefied Natural Gas (LNG) storage facilities can be used by Transco NTS to ensure that sufficient quantities of gas can be delivered in specific locations at the extremities of the transportation network to meet firm demand in line with the 1 in 20 network planning standard.

¹ Ofgem is the Office of the Gas and Electricity Markets Authority. The terms 'Ofgem' and the 'Authority' are used interchangeably in this letter.

² The modification proposal set out in this letter was originally proposed in accordance with the modification rules set out in Transco's then network code. Following the implementation of urgent modification proposal 0745 and in accordance with paragraph 2.1 of Part IV of the Transitional Rules, on 1 May 2005 modification proposal 0736 was deemed to be a modification proposal made in respect of the UNC in accordance with the UNC modification rules. On 3 May, the Modification Panel voted to allow the proposal to continue through the UNC modification process without re-consultation and modification proposal 0736 was assigned its new number.

Under the UNC, Transco NTS secures the transportation support it requires by 'constraining' a LNG site in a part of the network where such support is required. Transco NTS currently constrains three of the five LNG sites: Avonmouth, Isle of Grain³ and Dynevor Arms. When a site is 'constrained', Transco NTS sets minimum inventory levels which represent its estimate of the volume of gas in store needed at different times through the winter to ensure that the 1 in 20 security standard can be met. To ensure that the stock of gas at each site does not fall below the minimum inventory level, Transco NTS 'constrains' shippers use of the gas they hold in store at these sites to provide transmission support on peak days. In particular, Transco NTS requires shippers to maintain sufficient gas in store consistent with meeting its minimum inventory levels, and Transco NTS retains the right to use all or part of shippers' gas holdings at that facility to help alleviate a constraint as if the gas in storage and the deliverability rights were owned by Transco NTS (when the flow level at a specified part of the network exceeds a defined level). Shippers receive a rebate on their transportation charges to take account of the fact that their usage of the facility has been constrained. This is referred to as a constrained LNG rebate.

The opening minimum inventory levels at each of the constrained sites are determined by Transco NTS before the beginning of each storage year, taking account of supply and demand forecasts for the following winter. Prior to 18 October 2004, Transco NTS was able to book additional gas at these constrained sites if shipper bookings at these sites fall short of the opening minimum inventory level that Transco NTS had determined. These bookings were referred to as constrained LNG top-up.

On 18 October 2004, Ofgem accepted modification proposal 0710 '*Removal of Top-up arrangements*', which had the effect of removing 'national' top-up provisions from the network code (now UNC). National top-up gas is gas held (or placed) in store by Transco NTS to meet any deficits that Transco NTS identifies when its forecasts of available gas supplies from the market are compared with Transco NTS's forecast of firm demand in a 1 in 50 severe winter⁴. That is, national top-up is concerned with assessments of the aggregate supply/demand position in a given winter. However, in removing the provisions that related to national top-up, the provisions relating to constrained LNG top-up were also removed. Consequently, Transco NTS may no longer book constrained LNG top-up gas where shipper bookings at constrained sites fall below minimum inventory levels.

The modification proposal

Modification proposal 011 was proposed by Transco NTS on 3 January 2005.

In summary, this modification proposal seeks to again enable Transco NTS to book constrained LNG capacity and procure top-up gas at constrained storage facilities if shippers at these locations

³ The Isle of Grain has now been converted into an LNG importation and re-gasification terminal.

⁴ The 1 in 50 domestic security standard is defined as the availability of supplies of gas: over a year which would equal the aggregate annual demand for gas by those customers; and during the 6 months from October that would equal the aggregate demand for gas by those customers during such a 6 month period which is likely to be exceeded only in 1 year out of 50 years.

do not book sufficient storage to meet the opening minimum inventory level as determined by Transco NTS. This modification proposal also seeks to widen the definition of a constrained storage facility to include LNG importation terminals so that constrained services can be secured from these facilities. The modification includes the following elements:

- Transco NTS would book storage capacity to make up any shortfall in the event that shippers book insufficient quantities of storage capacity to ensure that the quantity of gas in storage during the winter period would be at least equal to the aggregate weekly minimum requirement;
- Transco NTS would purchase any capacity required for this purpose after completion of the annual storage invitation on the same late booking terms offered to other storage users;
- in respect of the gas to be held in store, Transco NTS would be permitted to procure the gas in accordance with the Procurement Guidelines, which would be amended accordingly if this proposal were implemented;
- Transco NTS would be able to surrender part or all of its capacity booking and receive full recompense, if another storage user subsequently required additional storage capacity;
- constrained withdrawals of gas that Transco NTS holds as constrained top-up would be made under the same terms as gas held by other storage users within that storage facility;
- the consequent imbalance would be cashed-out at the SMP sell price;
- the constrained top-up manager would be excluded from all neutrality charges or payments;
- the constrained top-up manager would be permitted to procure the required volume of transmission support services from LNG importation terminals either on an equivalent basis or as a gas flow service from the capacity holder(s) at that importation terminal. To retain equivalence to constrained storage facilities, in terms of licence incentives, it is proposed that LNG importation terminals be included within the UNC definition of constrained storage facilities; and
- the costs of booking constrained LNG top-up would be included within the constrained storage element of the Exit Incentive. This element of the incentive currently has a 100% sharing factor and no cap or collar and therefore Transco NTS would fully bear any additional costs above the target and fully benefit from any savings.

Respondents' views⁵

Two responses were received in relation to modification proposal 011. Of these, both supported the modification proposal.

One respondent supported the implementation of this modification proposal on the basis that it would assist Transco NTS in meeting its 1 in 20 peak day requirement. The other respondent supported the aim of this modification proposal but suggested that the prospective cost impacts on shippers are not clear.

Transco NTS's view⁶

Transco NTS suggested that whilst all available storage capacity at the constrained LNG storage facilities was booked by shippers in respect of the 2004/5 storage year, there was a possibility that this would not be the case for subsequent years and therefore that constrained LNG top-up arrangements would once more be required. Transco NTS suggested that the reintroduction of constrained LNG top-up would ensure that sufficient storage to maintain 1 in 20 peak day security would continue to be booked even if shippers had not booked sufficient storage to provide that level of security. Transco NTS therefore considered that implementation of the modification proposal would be consistent with the efficient discharge of obligations under its NTS licence and would therefore meet the relevant objective set out in Standard Special Condition A11(c). Namely, by enabling it to meet its 1 in 20 Peak Day transmission capability requirement set out in Standard Special Condition A9 of its licence as an efficient alternative to pipeline reinforcement.

Transco NTS also considered that the modification proposal was required to ensure that constrained LNG services could be procured both at storage facilities and LNG importation terminals. Transco NTS suggested that this proposal would potentially provide a further source of transmission support in competition with that available at storage facilities which would be consistent with the economic and efficient operation of the system.

Transco NTS was of the view that there would be no direct effect on Users' costs if this modification proposal were implemented.

Transco NTS recommended that the modification proposal be implemented immediately.

Ofgem's view

Having considered the modification report, the respondents' views and Transco NTS's view, Ofgem does not consider that modification proposal 011 would better facilitate achievement of the relevant objectives of the UNC. Ofgem considers that Transco NTS should conduct a review of the

⁵ This section is intended to summarise the principal themes of the respondents' view and is not intended to provide a comprehensive overview of the responses received.

⁶ This modification proposal was originally proposed in accordance with the modification rules set out in Transco's then network code. The UNC modification rules now provide for a Modification Panel view and Recommendation, this modification proposal was submitted to Ofgem containing a Transco view and Recommendation, as required at that time.

provision of constrained LNG to determine the extent to which there are contestable services. Ofgem recognises that such a review will take time to undertake. If Ofgem were concerned that shippers were not booking capacity sufficiently at constrained LNG storage facilities it may have been appropriate to accept this proposal whilst Transco NTS undertakes such a review. However, based on the information provided by Transco NTS it is not clear that there is likely to be insufficient capacity booked by shippers at constrained LNG storage facilities in the future. Ofgem has therefore concluded to reject the modification proposal.

The following sections sets out the reasons for this decision.

Standard Special Condition A11(c) The efficient discharge of the licensee's obligations under its transmission licence

Transco NTS has expressed the view that the implementation of this modification proposal would allow it to meet its licence obligation to provide 1 in 20 peak day transmission capability efficiently by ensuring that there is a minimum level of constrained LNG available from a storage facility as an economic alternative to pipeline reinforcement.

In considering whether the modification proposal facilitates the efficient discharge of the licensee's obligation to provide 1 in 20 peak day transmission capability, Ofgem considers that it is necessary to consider two key issues. First, whether Transco NTS has demonstrated sufficiently that there is likely to be insufficient capacity booked by shippers at constrained LNG storage facilities in the future. Second, notwithstanding the first point, whether, and if so to what degree, the reintroduction of constrained LNG top-up is an efficient solution to any shortfall in constrained LNG capacity bookings.

In respect of the first of these issues, Ofgem does not consider that Transco NTS has demonstrated that there will be insufficient capacity bookings at constrained LNG storage facilities – and therefore that there would be a requirement for Transco NTS to purchase constrained LNG top-up in the future⁷. Ofgem notes that, since the 2000/01 storage year, capacity has been almost entirely fully booked at all the LNG storage facilities⁸. Ofgem also notes that Avonmouth⁹, capacity has been fully booked each year since the 2000/01 storage year, and that all the capacity made available to shippers has been sold for the 2005/06, 2006/07 and 2007/08 storage years. Furthermore, it can be noted that the weighted average price of Avonmouth 1-year capacity sales for 2005/06 was

⁷ Ofgem notes that Transco NTS has only purchased constrained LNG top-up once, which was in the storage year 1999/2000 at Avonmouth and Dynevor Arms.

⁸ The only material exception to this is in relation to the Partington LNG storage facility, which, in the storage years 2000/01, 2001/02, 2002/03, had shipper capacity bookings of 40%, 66% and 75% respectively.

⁹ The 2005/06 weighted average price of 1 year capacity (ignoring sales to Transco NTS for Operating Margins purposes) was 99p/th (after the constrained LNG rebate is deducted) for a bundled unit at Avonmouth. This compares to a reserve price (net of constrained LNG rebate) of 3.2p/th.

substantially higher than the reserve price at the site¹⁰. Ofgem does not consider that Transco NTS has demonstrated that there is likely to be a shortage in constrained LNG capacity bookings.

In relation to the second point above, it is necessary to consider whether, even if there were insufficient capacity booked by shippers at constrained LNG storage facilities, it would be necessary for Transco NTS to book such capacity in order to discharge its 1 in 20 network planning standard efficiently. It can be noted that Transco meets its 1 in 20 network planning standard through a number of measures including:

- investment in pipelines;
- the use of interruptible transportation terms; and
- the use of storage facilities.

Ofgem considers that Transco has not clearly demonstrated that there is insufficient response available from such other transmission support services, or that, to the extent sufficient response is available, it could not be secured efficiently.

Ofgem therefore considers that Transco NTS has not fully demonstrated that this proposal would better facilitate achievement of relevant objective (c).

Standard Special Condition A11(a) The economic and efficient operation of the pipe-line system to which this licence relates

Reintroduction of constrained LNG top-up and the potential for distortion

Ofgem set out above its view that Transco NTS has not demonstrated that there is likely to be insufficient capacity bookings at LNG storage facilities. Notwithstanding this, Ofgem is of the view that even in the event of such shortfall, the reintroduction of constrained LNG top-up may not be an efficient and economic measure to address any 'shortfall' due to the potential for the mechanism to lead to distortions in the wholesale gas market.

Transco NTS has expressed the view that the ability to procure constrained LNG services both at storage facilities and LNG importation terminals would potentially provide a further source of transmission support in competition with that available at storage facilities which would be consistent with the economic and efficient operation of the system. However, Ofgem considers that the current arrangements for constrained LNG can give rise to distortions in the market for storage and transmission support services and the reintroduction of constrained LNG top-up would be likely to compound this existing potential for distortion. Ofgem considers that the reintroduction of constrained LNG top-up would result in a situation where the relevant LNG storage operator faced a guaranteed level of demand equal to the defined minimum inventory level, and that this could distort the operator's pricing decisions. More generally, the reintroduction of the constrained

¹⁰ The 2005/06 weighted average price of 1 year capacity (ignoring sales to Transco NTS for Operating Margins purposes) was 99p/th (after the constrained LNG rebate is deducted) for a bundled unit at Avonmouth. This compares to a reserve price (net of constrained LNG rebate) of 3.2p/th.

LNG top-up arrangements could lead to Transco NTS securing its transmission support services from constrained LNG without fully considering the potential availability of more efficient alternative sources.

Ofgem has for some time highlighted the potential for Transco NTS to procure transmission support services from alternative means on a commercial basis. In the July 2004 SO incentives document¹¹, Ofgem stated that there was a prospect of competing sources to constrained LNG and that this should be kept under review. At that time, it was decided that the SO incentive arrangements for the 2004-07 period would reflect the fact that Transco owned the LNG facilities and procured a large part of these services from those facilities. Since then there have however been announcements and construction of new sites (including storage and LNG importation sites) that could potentially offer substitute services. Rather than reintroducing constrained LNG top-up, Ofgem considers that it would be more appropriate for Transco to review these arrangements with an aim of considering more market based solutions for obtaining transmission support services and the introduction of a wider spread of contestable services as an alternative to the need to continue to use constrained LNG in the medium to long term.

Ofgem therefore considers that the reintroduction of constrained LNG would not better facilitate the achievement of relevant objective (a) of the UNC under Standard Special Condition A11(a) of the relevant gas transmission licence.

Standard Special Condition A11(d) - securing of effective competition between shippers and suppliers and/or between DN operators and relevant shippers

As set out in the above section Ofgem considers that the current arrangements for constrained LNG can give rise to distortion in the markets for storage and transmission support services and that the reintroduction of constrained LNG top-up would be likely to compound this existing distortion. Ofgem considers that this will in turn cause distortions in the incentives on shippers using storage facilities and hence have implications for competition between shippers. Furthermore, Ofgem considers that the implementation of this modification proposal could send out the wrong signals to Transco NTS regarding the need to develop alternative commercial transmission support services which would have a further detrimental effect on the securing of effective competition in these markets.

Ofgem therefore considers that the reintroduction of constrained LNG would not facilitate the achievement of relevant objective (d) of the UNC under Standard Special Condition A11(d) of the relevant gas transporters' licences.

Ofgem's decision

For the reasons outlined above, Ofgem has decided not to direct the relevant gas transporters to implement modification proposal 011 because it does not consider that it would better facilitate

¹¹ See for example, "Transco's National Transmission System Operator incentives 2004 – 2007",

achievement of relevant objectives of the UNC under Standard Special Condition A11 of the GT licence.

If you have any further queries, please feel free to contact Ed Carter on 020 7901 7304 or Kevin James on 020 7901 7181.

Yours sincerely

A handwritten signature in black ink, appearing to be 'S. Smith', written over the words 'Yours sincerely'.

Steve Smith

Managing Director, Markets

Signed on behalf of the Authority and authorised for that purpose by the Authority