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Dear Colleague,

New entry terminals to Transco's National Transmission System - Licence modifications

The Gas and Electricity Markets Authority (the Authority) has today, with the written consent of Transco plc (Transco), directed that modifications be made to Transco's gas transporter (GT) licence.

As part of this process, Ofgem has prepared a summary of the background to these modifications and the responses received leading up to this Direction. The paper is attached to this letter. A copy of the Direction and the associated licence modifications are available on the Ofgem website at www.ofgem.gov.uk.

Ofgem would like to thank all parties who have contributed to this process.

Yours sincerely

Kyran Hanks
Director, Gas Trading Arrangements
Authorised on behalf of the Authority

Modification Proposals to Transco's Gas Transporter Licence in relation to new entry terminals to Transco's National Transmission System

Background to the modification proposals and summary of responses received

Introduction

On 30 June 2003, the Authority issued a statutory notice (Notice) under section 23 of the Gas Act 1986 together with an accompanying document¹, setting out proposed modifications to Transco's gas transporter (GT) licence necessary to facilitate new entry points at Milford Haven in Pembrokeshire and Barton Stacey in Hampshire. The licence modification consultation period closed on 28 June 2003.

The Authority has today directed modification of Transco's GT licence, thereby implementing these changes. This paper is intended to accompany the Direction.

Background

As part of the modifications made to Transco's GT licence with effect from 1 April 2002, an entry capacity regime was established with the aim of ensuring that Transco has financial incentives to invest efficiently in response to customers' demands for entry capacity as signalled through entry capacity auctions. Key features of this regime are long-term auctions of entry capacity rights and an entry capacity investment incentive, which allows Transco to earn up to 12.25 per cent on pre-agreed estimates of the unit costs (unit cost allowances – UCAs) of providing incremental capacity for up to five years.

Following the conclusion of Transco's 2002-2007 price control review, a number of parties have approached Transco with proposals to bring additional gas supplies into Transco's national transmission system (NTS) and with proposals to develop storage facilities. The original proposals related to liquefied natural gas (LNG) import terminals at Milford Haven and onshore storage facilities at Humbly Grove in Hampshire and Welton in Lincolnshire.

Ofgem proposed that new entry points to the NTS should be treated under Transco's entry capacity investment incentive. Therefore, in order to accommodate the new NTS terminals, UCAs need to be specified in Transco's GT licence.

Under the Section 23 Notice, Ofgem proposed UCAs to apply to the Milford Haven and Barton Stacey entry points. The Barton Stacey entry point is a point on Transco's existing NTS and would be the NTS connection point for the Humbly Grove storage facility. Given the preferences of the relevant party, Ofgem did not propose a UCA for Welton at that time.

At the proposed Milford Haven entry point, there are plans for one LNG import terminal to be operational from 2006 and a possible second terminal to be operational at a later stage. Given the considerable uncertainty about the likely aggregate level of demand for capacity at Milford

¹ 'New entry terminals to Transco's National Transmission System Ofgem's views on Transco's proposals and Explanatory notes to accompany the section 23 notice of proposed modifications to Transco's gas transporter licence', Ofgem, June 2003.

Haven, Ofgem proposed two alternative UCAs, triggered according to the level of demand at that terminal signalled through the long-term auction arrangements, at a date to be determined by the Authority.

Summary of respondents' views

There were six responses (excluding Transco's) to the Notice. No objections were raised to the licence modification proposals.

The majority of respondents welcomed Ofgem's proposals to determine a UCA dependent upon the volume of capacity required at a new entry terminal to ensure that the most appropriate value is used.

Several respondents recognised that Ofgem would rely upon the results of bidding in the long-term auctions to provide a signal for incremental capacity. These respondents considered that given the development of new infrastructure, it was essential that Transco based its investment decisions on more than auction information by taking into account system planning data.

One respondent noted that Transco's proposed UCA threshold, as set out in the licence modification proposal, appeared to be somewhat arbitrary, but the respondent conceded that it was a reasonable demarcation of a large scale development.

Summary of Transco's views

Transco supported both the principles and Ofgem's proposal to establish new UCAs for Barton Stacey and Milford Haven. However, while it recognised that there may be merit in basing the UCAs on Ofgem's best estimate of per unit costs, it considered that this approach departed from the principles used at existing entry points. Transco commented that the proposed zero value UCA for Barton Stacey would not provide it with a financial incentive to respond to demand for entry capacity. Transco considered that it would have been preferable to reconsider the approach to setting all UCAs as part of the next price control review.

Additionally, Transco considered that it would be inappropriate to rely on auction signals alone when determining investment plans. Transco considered that its willingness to invest at its own risk would be dependent on an assessment of the potential risks and rewards. Transco remained unconvinced that the regulatory treatment to support investment at its own risk was sufficiently clear.

Transco requested a typographical correction to the proposed definition of PRIORCIOEC^j, by adding the subscript 'm', in order to clarify its intention.

Ofgem's views

In response to views raised during the consultation, Ofgem reiterated its view that we would place considerable weight on demand signalled through the financial commitments resulting from auctions, given their clear reliability, as opposed to signals given by the traditional planning process.

In Ofgem's June 2003 accompanying document, Ofgem stated that, in principle, it would be unwilling to approve a proposal to release obligated incremental entry capacity at a new

terminal to the extent that it assumes that demand additional to that signalled in the auction will be signalled at some later date. That view has not changed.

However, in response to the possibility of demand being signalled in an open season for capacity at Milford Haven, which increases in the initial period of a proposal to a level in excess of 500 GWh/day, Ofgem has discussed with Transco that Transco may, in this circumstance, apply to release the higher level of demand as obligated incremental entry capacity from the earlier date.

This does not represent a change from the policy expressed in our accompanying document, but merely a clarification of a particular issue raised by Transco.

The Authority has acknowledged Transco's request to make a typographical change to PRIORCIOEC^j and has amended the term accordingly.

Conclusions

Having carefully considered the responses summarised above, the Authority does not consider that any material change is required to the proposed licence modification.

The Authority has concluded that the licence modification proposals, as amended, fall within section 23 of the Gas Act.

On 13 August 2003, Transco (as the Licensee) gave its written consent to the licence modifications, as amended. The Authority has also received confirmation from the Department of Trade and Industry that the Secretary of State does not intend to exercise her power of veto under paragraph 5 of section 23 of the Gas Act 1986, with respect to the proposed modifications. As required under the Gas Act 1986, the Authority also gave notice of the proposed modifications to the Health and Safety Executive and to energywatch and did not receive any objections from these parties to the proposed modifications.

In this context, the Authority has today issued a Direction to implement the proposed modifications to Transco's GT licence with effect from 11 August 2003.